

**THE RELATIONSHIP BETWEEN FORMAL MICROFINANCE INSTITUTIONS
AND THE POOR IN BEIRA-MOZAMBIQUE**

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DECLARATION

I declare that this research report is a product of my own work. It is submitted to the Faculty of Humanities of the University of the Witwatersrand, in partial fulfilment for the degree of Master of Arts in Development Studies. This study is unique; it has not been done before nor submitted for any other degree or examination in any other institution, academic or non-academic.

Johannesburg, 14 February 2007

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ABSTRACT

This paper examines the relationship between microfinance institutions and the poor in Beira-Mozambique and the benefits accruing from the established relationships. The study focuses on access to credit and the promotion of entrepreneurship among the target group. The study concludes that the institutions and the target group, especially active clients, treasure close long-term relationships and strive to build and sustain such relationships. However, the relationships have thus far had only a limited, albeit promising, impact on the sustainability of the institutions, access to credit and the promotion of entrepreneurship among the target group. Another major finding is that clients already in the credit relationship do not have serious problems accessing credit upon successful repayment of previous loans. However, those seeking to enter credit relationships face strict entry requirements. In short entering credit relationships is more difficult than staying in them.

Key words: microfinance; micro-credit; relationship; sustainability; lending; poor access; entrepreneurship; lending technology

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ABREVIATIONS

ADB	Asian Development Bank
BoM	Banco de Moçambique
BPD	Banco Popular de Desenvolvimento
BRI	Bank Rakyat Indonesia
C	Client
CGAP	Consultative Group to Assist the Poor
CIA	Central Intelligence Agency
EIU	Economist Intelligence Unit
ERP	Economic Rehabilitation Programme
ESRP	Economic and Social Rehabilitation Programme
FRELIMO	Frente de Libertação de Moçambique
GDP	Gross Domestic Product
IMF	International Monetary Fund
IFS	Institutional Financial Sustainability
LO	Loan officer
MFIs	Microfinance Institutions
MZM	Mozambican Metical
NGO	Non-Governmental Organisation
RENAMO	Resistência Nacional de Moçambique
RoZ	Republic of Mozambique
SMEs	Small and Medium Enterprises
UNDP	United Nations Development Programme
USD	United States Dollars

DEFINITION OF KEY CONCEPTS AND TERMS

Microfinance and micro-credit

According to Shama (2001), microfinance refers to the provision of a broad range of financial services such as deposits, loans, payment services, money transfers and insurance to the poor. van Bastelaer (2000) defines micro-credit refers to small amounts of money between USD\$50 and USD\$ 4000 lent to low income households for either consumption or investment, and formal micro-credit refers to money borrowed from registered institutions in the country in which they operate. In this paper microfinance refers to the financial services designed to fit the needs and capacity of low income households. The terms microfinance and micro-credit are often used interchangeably.

Sustainability and institutional financial sustainability

Sustainability refers to the ability of the microfinance institution or programme to serve a large number of the poor on a permanent basis while at least covering its operation costs. Institutional financial sustainability (IFS) refers to the ability of the lending institution to cover all its costs and make a profit (Littlefield, 2004).

Relationship lending

A relationship is defined as “*the connection in the form of long-term close ties between a financial intermediary and a borrower that goes beyond the execution of simple, anonymous, financial transactions*” (Nalukenge, 2003, p.8). Close, long-term relationships exhibit high levels of mutual consideration for each party’s success through a commitment by the lender to providing quality service at fair and sustainable terms, and the clients’ commitment to purchasing and repaying loans (Berger, et al., 2001).

Access to credit

Access refers to the ease with which clients can and are indeed entering credit relationships with lending institutions. It is linked to institutions’ ability to devise target group friendly lending technologies and create demand through social mobilisation. Beck and da la Torre (2004) define access as multidimensional, covering issues such as: geographic access i.e. the extent to which potential clients can reach the lenders’ offices or branches conveniently, at a reasonable cost and in a reasonable time; socioeconomic access, which involves the costs, the fees and the confidence to enter credit relationships (p.2).

The poor

In this study the concepts poor, target group and low income microentrepreneurs are used interchangeably to refer to individuals or households that lack a socially acceptable amount of money and/or material possessions and socio-economic opportunities to enter credit relationships with traditional banks, are credit constrained and have the potential to improve on their condition given enough financial, technical and moral support.

Entrepreneurship

Entrepreneurship refers to the ability of the target group to prudently invest loans to generate more money and improve their own situation (Cunningham and Lischeron, 1991).

Lending technology

Lending technology refers to;

The entire range of activities carried out by a credit granting institution which have to do with selecting borrowers, determining the type of loan to be granted, the loan amount and maturity and the way in which it is to be secured, as well as the monitoring and recovery of loans (Schmidt and Zeitinger, 1994, p.106).

1. INTRODUCTION

1.1 Background

Formal microfinance has grown in importance in the last few decades as a result of its verified potential for meeting the financial needs of poor households and micro-enterprises. Researchers have identified the lack of money to grow or diversify income generating activities and smoothing consumption as one of the greatest challenges facing poor households and micro-enterprises (Schreiner, 1999; Littlefield et al., 2003; Pagura, 2003). For these reasons, microfinance is regarded as one of the most powerful tools for fighting poverty and social deprivation (Morduch and Haley, 2002; Sylla, 2005). Despite this recognition, the considerably high demand for credit, and the proved bankability of the poor (Rhyne, 1998), access to credit is still far from satisfactory. Robinson (2001) estimates that, *“about 90% of developing world’s population does not have access to microfinance institutions”* (p.96).

The problem of access to credit by the poor has been, by and large, attributed to lending technologies that fail to solve information related problems- adverse selection and moral hazard-, and contract enforcement problems in dealing with the target group. These technologies often resemble the traditional banking practices that base their lending on hard information- financial statements and traditionally acceptable collateral e.g. houses and land titles (Boot, 2000) - and have high levels of red tape (Ongena and Smith, 1998).

Modern financial intermediation theory regards the use of unconventional lending technologies built around close long-term relationships between lenders and micro-entrepreneurs as promising alternatives for militating against lending related risks, and

improving access to credit to the target group (Schmidt and Zeitinger, 1994; Petersen and Rajan, 1994, 1995; Ongena and Smith, 1998, 2001). One of the most celebrated lending technologies is called *relationship lending* (Berger and Udell, 2002, 2005). The feasibility of this technology, it is argued, depends on the ability of both lenders and clients to take each other's concerns on board and ensure that they both gain from the relationship (Berger et al, 2001).

Client-lender relationships are established through several practices and mechanisms, which include but are not limited to: The location of branch offices near the target group to facilitate continued contact; the adoption of marketing strategies such as personal selling which allow close interactions between the lenders and the target group; provision of quality services tailored to the individual needs of the target group and/or individual members of the target group on a recurrent basis; progressive lending which implies the issuing of small initial loans which increase as the relationship between the lender and the borrower matures; the provision of services other than financial e.g. counselling, mentoring and training; and occasional meetings between lenders and clients to discuss their credit relationship and related issues.

It is worth noting that much of the relationship building responsibility lies with the lenders, since their survival depends on the borrowers' capacity and willingness to repay the loans. This explains why, it is the lenders' rules that dominate the relationship. Nonetheless, the borrowers' contributions for the establishment of the relationships are indispensable. Borrowers' contributions include: The continued purchasing of the products offered by the

lenders, referrals¹, and loyalty in terms of keeping to the terms and conditions established in the credit agreement, such as timely repayment.

Close long-term relationships between borrowers and lenders can be beneficial to both parties. Lenders gain substantial amounts of information needed for making credit decisions and enforcing contracts, hence reducing risk related costs (Berger and Udell, 2002). Furthermore, in *relationship lending*, bureaucratic procedures associated with verification of documents and collateral requirements are reduced, implying a reduction in costs for both lenders and borrowers (Elyasiani and Goldberg, 2004). Lenders can gain from the sustainability and reputation point of view, while borrowers can gain greater access to credit and other financial services that enhance the growth and development of their micro-enterprises and consequently their wellbeing (Cole, 1998).

1.2 Overview of the study

1.2.1 Aims of the study

This study examines whether formal microfinance institutions and the poor (target group/low-income micro-entrepreneurs) in Beira-Mozambique take each others' concerns on board as the institutions strive to sell their products and attain financial sustainability and profits on the one hand, and the poor on the other hand endeavour to have access to financial products, particularly credit.

The study specifically aims to examine whether in dealing with the poor, the institutions invest in keeping as close as possible to the target group both in physical and emotional

¹ Referrals have to do with clients advising and recommending other clients to join in credit programmes

terms by locating branch offices in neighbourhoods where the poor commonly live, while providing them with financial education, incentives and moral support to enable them to enter and stay in credit relationships.

In the same vein, the study examines whether the poor take their credit responsibilities, such as repayment, seriously and understand that good repayment behaviour is instrumental for the survival of the institutions and their own (the target group's) continued access to credit. Furthermore, the study examines whether the relationships established between the institutions and the poor are one-off or long-term relationships and whether the parties are satisfied with one another- the clients with the terms, conditions, and services offered by the institutions; the institutions with the borrowing, investment and repayment behaviours of their clients. The study also examines the benefits accruing from the established relationships, with a focus on access, sustainability and the promotion of entrepreneurship among the target group. The study focuses on one product – micro-credit.

1.2.2 Research question

What kind of relationship has been established between formal microfinance institutions and the poor (target group) in Beira Mozambique?

1.2.3 Rationale

Despite the increasing use of relationships in lending worldwide, with the intuition of making credit more accessible to the poor, there is hardly any research on the nature and role of client-lender relationships in micro lending in Mozambique. Furthermore, international research on issues such as the impact of close long-term relationships between clients and lenders on interest rates and loan guarantees remain largely

inconclusive, with different empirical studies showing different results; hence the researcher's interest in finding out what actually happens in the context of Beira-Mozambique, where no such research had been done before. With this study the researcher hopes to make a modest contribution to *relationship lending* theory.

1.2.4 Findings

The study concludes that the institutions and the target group, especially active clients, value high close relationships and invest time and effort to build and sustain such relationships. These relationships are mainly characterised by personalised and quality service, repeat borrowing and a commitment to repayment.

However, the relationships have thus far had a limited, albeit promising, impact on the sustainability of the institutions, access to credit and entrepreneurship among the target group. In general, a small number, mainly comprising relatively well-off households and micro-entrepreneurs benefit from easy and repeated access to credit and manage to develop their micro-businesses thanks to the established relationships. The majority of the low-income households and survivalist micro-entrepreneurs find it difficult to meet the requirements for entering credit relationships and as such are left out of the formal credit market. It is, however, important to note that those who have access to the microfinance institutions would hardly qualify for credit with traditional commercial banks; as such the contribution of these institutions in expanding financial services to the poor is noteworthy.

The reasons for the limited impact of the relationship on sustainability, access and entrepreneurship include: (i) the relatively young age of the lending institutions, i.e. five (5) years; (ii) high operational costs; (iii) the macroeconomic environment, including

limited profit opportunities resulting from low per capita incomes, limited markets and a lack of adequate infrastructure. Despite all these challenges, the efforts made by both institutions to relate to the target group and provide them with credit are promising and praiseworthy, so is the cooperation of those among the target group who are actually in credit relationships with the two institutions. It is clear, however, that relationship lending is not a panacea, and cannot, by itself, overcome the challenges of poverty in Mozambique.

1.3 Country overview: Mozambique

Mozambique has a surface area of 799,380 sq. km and is home to 19,686,505 people, about seventy percent (70%) of whom live below the poverty line (CIA-The World Fact Book: June, 2006). Mozambique was a Portuguese colony for about five hundred (500) years. In 1975 it gained independence from Portugal under the leadership of FRELIMO (The Front for the Liberation of Mozambique) who took over power and established a one-party Marxist state. Between 1976 and 1992 the country was embroiled in a civil war with RENAMO (Mozambique National Resistance) fighting the FRELIMO led government. In 1989 Marxism was abandoned and in 1990 a new constitution based on economic and political liberalisation came into being (Fraser and Candido, 2001).

In 1994, 1999 and 2004 multi-party elections were held for the presidency and parliament, FRELIMO won the elections in all instances (Dalglish and Bradley, 2006). At present, Mozambique is considered an example of a politically stable country emerging from a prolonged and devastating civil war (Fraser and Candido, 2001).

The sovereign state of Mozambique inherited a declining economy at independence, due to the prolonged years of the struggle for independence (1962-1974), the sudden withdrawal

of the Portuguese accompanied by high levels of sabotage (Dalglish and Bradley, 2006), losses of revenue resulting from a prolonged civil war (1977-1992), the failure of government's Marxist policies of planned economy and its dedication to the liberation of other African counties particularly its undivided support for the struggle for independence in Southern Rhodesia (now Zimbabwe) and against apartheid in South Africa, which led to systematic destabilisation by both the Southern Rhodesian and the Apartheid regimes. This destabilisation included support for RENAMO during the civil war (de Vletter, 1999; Fraser and Candido, 2001).

Efforts were made in the 1990s to improve the socioeconomic situation in Mozambique and considerable gains were made. Peace agreements were made to end the civil war which effectively ended in 1992. With the end of the war and the beginning of the fall of the apartheid regime in South Africa, the stage was set for change in Mozambique, and the opportunity was well taken. After a series of economic rehabilitation programmes- Economic Rehabilitation Programme (ERP) and Economic and Social Rehabilitation Programme (ESRP) of 1989-1990, macroeconomic stability was re-established in 1996, (EIU 2000; Fraser and Candido, 2001, p.24).

However, in early 2000 floods devastated most of the country and affected the economy adversely (Dalglish and Bradley 2006). But improvements were back on course two years afterwards. At present, economic performance is considered impressive. The World Bank and the IMF believe that Mozambique has now entered a period of macroeconomic stability and sustained economic expansion. The 2005 estimate of the GDP growth rate is put at seven percent (CIA: World Fact Book, 2006). Nonetheless, Mozambique remains one of the poorest and most aid dependent countries in the world (World Bank, 2006).

1.3.1 The city of Beira

Beira, where the research was carried out, is the provincial capital of the central province of Sofala. It is Mozambique's second largest city and port. It is home to about six hundred thousand (600 000) inhabitants. During the atrocious seventeen year civil war the province of Sofala suffered the most. Today, it has the reputation of being Mozambique's poorest province (RoZ, 2003).

As an economy, Beira is struggling: *“physical infrastructure is broken and its people appear to have few opportunities to progress”* (Dalglish and Bradley, 2006, p.3). Among the many challenges facing the people, the government and the entrepreneurs of Sofala include dealing with *“low levels of literacy and educational standards, high levels of unemployment, low productivity of households, weak development of infrastructure, bureaucratized government, corruption and a very high mortality rate from curable diseases”* (Dalglish and Bradley, 2006, p.3).

1.4 Microfinance in Mozambique

In the 1990's microfinance activities intensified in Mozambique. During that period, sustainability was not a major consideration. Financing mostly took the form of grants, and was based more on volume and spread than on financial viability and permanence. The institutions were mostly short-term NGO projects, which were dependent on subsidies and operated in an unregulated environment (Fraser and Candido, 2001). Repayment and loan recovery rates were catastrophically low, hence their limited albeit important contribution to improving the welfare of the poor who had limited sources of credit (de Vletter, 1999).

In 1998 the Bank of Mozambique issued a decree (47/98) to regulate microfinance activity. This decree allowed all institutions and individuals registered under the decree to provide credit but not to capture savings, i.e. people could only borrow from the institutions but not deposit any money except repayments. This was probably because the institutions were not big and organised enough to ensure their permanency and consequently the security of the savers. As the sector grew and the regulatory framework improved, the institutions were allowed to provide other services including savings, issues of best practice started gaining ground and sustainability became an important issue, and more institutions entered the sector (Fraser and Candido, 2001).

The minimalist approaches to lending, which pay particular attention to sustainability through focusing on loan recovery and cost recovery pricing, gained prominence. Today, microfinance institutions are more advanced in terms of institutional structures, ownership and sustainability relative to NGO credit projects and state run development banks such as Banco Popular de Desenvolvimento (BDP) which dominated the sector in the 1990's (Fraser and Candido, 2001).

Despite the progress made so far in the development of the microfinance industry in Mozambique and the demand for microfinance products by the majority of the poor, the emerging formal sector does not yet reach the majority of the poor, especially the poorest of the poor, since the institutions largely targeted low risk clients (Athmer and Hunguana, 2004). Only fifty-thousand² clients are served by the industry as a whole out of an estimated, eight hundred thousand people who could benefit from Microfinance credit services alone (Opportunity International, 2005). Therefore, much more needs to be done if

² The basis on which these figures have been established are not indicated in the source , which makes it difficult to establish the extent of their reliability .

the industry is to have any real impact on poverty alleviation. Lenders have to take more risk and come up with innovative lending methods that allow those with no collateral, business experience etc., to enter credit programmes without of course leading to high levels of indebtedness among the poor and bankruptcy among lenders.

In Beira, where the study was conducted, there are more than thirty thousand potential clients but less than ten thousand have access to formal credit³. Poverty in the region is acute and it will require more than microfinance to overcome it. It would in fact be helpful for the expansion of microfinance if poverty could be reduced through other means as poverty itself is a major constraint on access to microfinance. How this could be achieved in a global environment in which most people overlook poverty as a constraining factor to access to credit requires further and thorough research.

³ The numbers are estimations provide by Mr. Boris senior officer of institution A no basis for these estimations were provided.

2. RESEARCH METHODOLOGY

The study was carried out using qualitative research methods. Traditionally used in social sciences, qualitative research aims to investigate and understand human behaviour within a given context. It is more descriptive than definitive (Brusky and Fortuna, 2002). Qualitative research does not deal with statistical measurements or proportions, but rather behaviours and attitudes. Data collected in a qualitative study enables the researcher to, not only identify tendencies but more importantly, to understand the motivations behind the behaviours, habits or attitudes that create these tendencies. With it, the researcher gets a holistic picture of the object under study (Kane, et al., 2001).

For this particular study, the method facilitated the examination of the nature of the relationship established between the MFIs and the poor. The views and the experiences of the actors, which are central to the study, were substantially captured and used for understanding the nature of the relationship and the inherent benefits to both lenders and borrowers. This was achieved through interviews with clients, both potential and active, senior officers and loan officers. Both primary and secondary sources were used for gathering the data necessary for this research. Secondary sources used include books, annual reports of relevant microfinance institutions, journals, working papers, World Bank and United Nations literature and government information, including information from other relevant organizations. Primary data was collected using semi-structured interviews.

2.1 Sample and Sampling

To explore the nature of the relationship between formal microfinance institutions and the poor in Beira, thirty one (31) respondents were interviewed. Twenty (20) clients, from two formal micro-credit institutions, involved in small to very small businesses in both the formal and informal markets in the city; five (5) potential clients⁴; four (4) loan officers, two (2) from each institution, and two (2) senior officers, one from each institution. The first four (4) respondents were selected randomly from the two large markets in the centre of the city of Beira, one formal and the other informal. For the remaining sixteen (16) the snowball technique was used to identify and interview them. This means that the sixteen (16) respondents were referred to by the first four (4) respondents.

2.2 Method of data collection

The researcher carried out all the interviews with the key respondents himself. The interviews were semi-structured and took a minimum of forty-five (45) minutes each, with some taking a bit more than (60) minutes. Semi-structured interviews allowed a thorough interaction with the interviewees. They were mainly informal and flexible, allowing the conversations to flow and a broad range of information to be collected. The dialogical nature of semi-structured interviews gave the process of information seeking an important edge, consistent with Huysamen (2001)'s observation that, "*...semi-structured interviews allow the interviewer to use probes with a view to clearing up vague responses, or to ask for incomplete answers to be elaborated on*" (p.160). It is this strength inherent in semi-structured interviews which influenced the selection of this instrument, the objective of which was to maximise information gathering.

⁴ Potential clients refer to those among the target group who may qualify to enter credit programmes but are not in nay credit programme

In each interview there was scope to explore issues of particular interest which arose in the course of the conversation. They allowed contact with people who possessed the information sought. The contact, in its turn, was important because the interviewer could get additional information from the interviewee from gestures or facial expressions which can not be obtained otherwise. Key to its effectiveness were the efforts made to focus on particular subjects and to ensure that the conversation did not stray on to irrelevant information. This was not easy given that interviews tended to say more of what they wanted to say and less of what the interviewer wanted to hear, nonetheless with patience and waiting the interviewees came to the point.

One of the main challenges faced by the research during data collection is related to the time consuming nature of interviews, some interviewees were reluctant to spend much time being interviewed. After pleading with them for the interviews they finally agreed to brief, albeit not rushed interviews that took 45 minutes on average, with some lasting a little more than 60 minutes.

2.3 The selection of the case study

The study is a case study of the city of Beira. The choice of city was informed by the researcher's need for convenient access to key respondents since the researcher lives in this city. The advantage was that the researcher incurred very few expenses and saved on time, the two critical constraints anticipated in the research. Furthermore, and in fact more importantly, the city is located in one of the provinces most notorious for poverty and as such it provided an excellent opportunity to examine the relationship between the poor and formal microfinance institutions.

In order to facilitate the examination of the relationship and the benefits thereof from both the clients' and institutions' perspectives, two (2) institutions, which are treated in the paper as institution A and B, were selected on the basis that they are among the largest institutions in the country and the city itself. Each of the two institutions has operations in several cities in Mozambique. It is worth noting that it was not the purpose of this study to assess the general performance of the institutions but simply to establish the kind of relationship established between MFIs and the poor. The use of the case studies simply provided a broad picture of the operation of the institutions, the approach and lending technology used, the financial situation, levels of outreach, the general behaviour of the clients and the established relationships.

Moreover the use of such case studies enabled the researcher access to important key respondents within these institutions. The researcher was, therefore, able to acquire in-depth knowledge and understating of the lending technologies and the inherent relationships more effectively. This provided the researcher with substantial background information and facilitated the examination of the nature of the relationships. The identities of the institutions and the respondents have been kept confidential, at the request of most interviewees. For the sake of consistency all the names of the interviews used in this paper are pseudonyms.

2.4 Data analysis

Straus and Corbin (1990, in: Maykut and Morehouse, 1994, p.122) describe three approaches to analysing qualitative data. The first approach, they compare with the work of a journalist in which the data is presented without any analysis. The goal being to let the research participants speak for themselves as much as possible. The second approach involves an attempt by the researcher to accurately describe what she or he has understood by reconstructing the data into recognisable reality for the people who have participated. This approach requires some selection and interpretations of the data and the research has to weave descriptions, field note quotations and their own interpretations into a rich believable descriptive narrative. The third approach is theory building. This requires the highest level of interpretation and abstraction from the data in order to arrive at the organising concept and tenets of a theory to explain the phenomena of interest (Maykut and Morehouse, 1994, p.122).

The data analysis approach used for this research lies between the first and the second approaches, with a bias for the later. Interview transcripts and notes from the observation of credit analysis undertaken by loan officers with active and potential clients were analysed periodically using a number of thematic headings. Quotations that captured commonly made arguments or observations in a succinct manner were selected. Quotations from respondents that represented deviant cases were also highlighted and selected. As the data was sorted, patterns, themes and categories were identified. This sorting facilitated the analysis of the data and the drawing of research conclusions. Throughout the analysis the researcher's evaluation and judgment of information gathered, was employed.

2.5 Ethical considerations

Ethical issues, such as voluntary participation, informed consent, anonymity and confidentiality, were privileged in this research, consistent with de Vans (2001). The participants were given full information of the reasons for the research and their role in it. They were further assured that all the information collected from them would be strictly used for the purpose of the research and nothing else. Most interviewees requested that their identities be kept anonymous and for the sake of consistency all names mentioned in this report are pseudonyms.

2.6 Outline of the Report

Chapter I introduces the study. Chapter II presents the methodology used for the study. Chapter III is a review of the relevant literature. Chapter IV presents an analysis of the profile and the lending technology employed by the two institutions with reference to client lender relationships. Chapter V presents an examination of the nature of the relationship established between the two institutions and their clients. Chapter VI examines the benefits accruing from the established relationship. Chapter VII presents the concluding remarks.

3. LITERATURE REVIEW

The existing literature on microfinance in Mozambique focuses mainly on the evolution of microfinance in post-conflict Mozambique, from relief programmes to formal financial intermediaries and the industry's poverty outreach and impact⁵. Consequently the researcher did not find any literature dealing with the relationship between formal financial institutions and clients in Mozambique. In this regard, this study differs substantially from the studies done in Mozambique to date, in that it particularly explores client lender relationships, something no other study has done in Mozambique.

Internationally, however, there is a large body of literature on client lender relationships which focuses particularly on the importance and the benefits or lack of benefits accruing from such relationships. These studies hardly focus on exploring the ways in which the relationships are built. Again this study differs slightly from many of these studies in that it focuses on the nature of existing relationships, how they are built and sustained. It additionally looks at the benefits or lack off accruing from the established relationships.

3.1 The non-conventional lending technology

Recent financial intermediation literature on lending to micro, small and medium enterprises show that commercial lenders can successfully reach the target group by drawing on non-conventional lending technologies in extending credit to these enterprises (Berger and Udell, 2005; Kano et al., 2006). The non-conventional lending technology

⁵ See de Vletter, 1999, 2001; Fraser and Candido, 2001, Fraser and Bne Saad 2003; Athmer and Hanguana, 2004

described as *relationship lending* is perceived to be appropriate for lending to low income individuals and small business that often do not have standard financial records and conventionally acceptable guarantees such as houses and land titles (Boot, 2000).

The lending technology is based on what Berger and Udell (2002, 2005) call 'soft information'. Soft information includes the character, reliability and estimates of the cash flows of the applicants; the information is acquired by loan officers through contact with the entrepreneur and the local community over time. In the case of BancoSol and the Grameen Bank that value strong long-term relationships with their clients, several mechanisms are used to build such relationships. Among the mechanisms used are: Meeting with clients regularly through periodic meetings or/and regular site visits, issuing small initial loans which increase as the client borrows repeatedly, frequent repayment schedules, encouraging borrowers to become savers and in the specific case of the Grameen Bank borrowers become shareholders (Navajas, 1999).

As a result of repeated contact with the target group, the loan officers (institutions) develop quasi-personal relationships with them, which makes it ease to elicit the information needed for establishing borrower creditworthiness and providing them with products, services and the support borrowers need to succeed in the credit relationship (Navajas, 1999; Berger and Udell, 2005).

The development of quasi-personal relationships of a long-term nature between lenders and clients does not only help lenders respond adequately to the needs and situations of their clients but can also foster client loyalty to the lender. This loyalty is vital for the growth of loan and borrower portfolios, for lowering the costs of provision, enhancing

repayment performance and profitability of the business for the lender (Petersen and Rajan, 1994; Dunn, 2002; Elyasiani, 2004).

3.1.1 Organisational structure

Lending based on relationships is complex given that soft information is difficult to document and transfer to others. This inherent complexity requires lenders to develop organisational structures that facilitate the development and sustenance of strong long-term relationships with clients while ensuring accountability of staff (Kano, 2006). A more flexible and decentralized organizational structure is often considered more appropriate, because information obtained from relationships is often unquantifiable and difficult to communicate through a rigid hierarchical and centralised structure typical of traditional banks (Berger and Udell, 2002).

Therefore, institutions that base their lending on close long-term relationships with their clients need to have decentralised and flexible organisational structures. One of the most important innovations in this regard is making loan officers responsible for specific clients. In this regard, Schmidt and Zeitinger (1994) state that under *relationship lending*, “... [usually] a single loan officer is responsible for the entire loan-granting process as well as its relationship with the client after disbursement of the funds” (p.129).

The rationale behind making a loan officer responsible for the entire life cycle of the loan is “that the loan officer has the most personal contact with borrowers and the people around the borrowers and is in a better position to observe the enterprise and household financial conditions” (Berger and Udell, 2002, p. 8). The loan officer is therefore the most

important link between the institution and the client hence the need for the loan officer to have some degree of discretion and influence on loan decisions.

3.1.2 Reducing agency problems between loan officers and top management

With a great deal of power delegated to the loan officer in *relationship lending*, the institutions need to put in place mechanisms to monitor the loan officer to avoid agency problems between top management and the loan officers (Berger and Udell, 2002). Schmidt and Zeiting (1994) argue for the need for a standardised credit analysis forms that ensure objectivity of the data collected by the loan officers; and that the approval or rejection decision is taken, at the last instance, by a credit committee. They further argue that performance based pay or incentives “*calculated using criteria which include the delinquency and default rate are critical for ensuring loan officers’ objectivity and support for applications based on solid economic considerations rather than staff members’ personal wishes or preferences*” (Schmidt and Zeiting, 1994, p.130).

3.2 Risk and delinquency management

3.2.1 Thorough initial screening

Lenders often subject applicants to thorough initial screening processes, which are critical for reducing the probability of adverse selection and moral hazard and above all for ensuring that once in the actual credit relationship the clients can actually stay in it without harming others and themselves by failing to repay their loans (Ledgerwood, 2001; Beck and de la Torre, 2004; Schmidt and Zeiting, 1994). In establishing the credit worthiness

of an applicant, loan officers collect the necessary data from both the business premises and the home of the applicant, since in dealing with the target group it is difficult to draw a clear distinction between investment and consumption.

In order to ensure that borrowers can repay their loans even if their business is not doing well, lenders usually grant loan sizes which are below the overall income of the particular client. In so doing, they reduce the risk to the institution (Ledgerwood, 2001; Beck and de la Torre, 2004; Schmidt and Zeitinger, 1994). One can however argue that giving smaller sizes than clients ask for can actually increase the risk of default because the loan may not be enough for making a profitable investment, leading to the failure on the part of the client to get enough returns to manage repayment.

Furthermore, a thorough initial screening is important for the development and maintenance of strong lasting relationships between the client and the lenders because it ensures that only clients with potential and the ability to sustain long-term credit relationships, enter credit programmes; this kind of precaution is often responsible for low levels of outreach. Lenders should be ready to take a little more risk when dealing with the poor. Otherwise they will end up reaching only a small number of the poor by excluding most of whom may only appear to be bad risk. Some could indeed be good risk clients provided they get enough moral support and mentoring.

Professor Yunus' initiative of encouraging every one of his 12 000 employees in 2004 to include a beggar in their pool of clients (Mainsah et al. 2004) could be adapted by other institutions to include at least one customer who does not meet the requirements of entering credit relationships (such as collateral) but have some potential to use the money

productively. This kind of practice will help lenders expand their outreach and have greater social impact, which is in fact the professed mission of the microfinance industry.

3.2.2 Progressive lending

Progressive lending entails issuing small initial loans which increase with subsequent applications. It *“has the unique advantage of testing the borrower with small loans, allowing lenders to develop relationships in time and sort out potential defaulters before the loan scale is expanded”* (Ghosh and Ray, 1996, p.493). The effectiveness of progressive lending as a risk management tool and as an incentive to repay is *“enhanced by promising to extend steadily larger loans over time to good customers, because typically borrowers desire larger and larger loans, the promised increases enhance the borrowers’ loss from being cut off”* (Schmitz and Zeiting, 1994, p.123).

3.2.3 Regular repayment schedules

Regular repayment schedules and short terms to maturity not only show that the institutions are serious about repayment but also help screen out undisciplined borrowers, as well as providing the microfinance institutions with a steady flow of information on client behaviour (Sanjay and Mansuri, 2003). This information can provide loan officers with early warning about emerging problems and make it possible for appropriate action to be taken promptly, in so doing reducing the risk for the lender.

3.2.4 Collateral

Collateral has traditionally been used to mitigate adverse selection and moral hazard (Brau and Woller, 2004). It serves to discourage bad risk clients from taking loans which they know they are not capable of repaying (Krahnén, 2000). This allows the lender to avoid attracting a pool of clients who can not sustain long-term credit relationships. Asking clients to pledge collateral does not only help lenders establish borrowers' credit worthiness, but also prevents irresponsible use of borrowed money (moral hazard) due to knowledge that collateral will be forfeited in the event of default (Ghosh et al., 2000).

In *relationship lending* collateral is also used for the purposed elucidated above. The difference between relationship lenders and conventional lenders, in as far as requiring collateral is concerned, lie on the range of goods acceptable as collateral. While conventional lenders usually accept property or goods with a high salvage value, like houses, factory machinery and the like, relationship lenders will accept almost anything that the poor can afford to pledge as long as there is proof the clients value the goods. This includes inventory, household furniture and appliances, which have a low resale value but are highly esteemed by the owners (Schmidt and Zeitinger, 1994).

Critics will, correctly, argue that requiring collateral in relationship lending contradicts the principles of relationship lending and reflects the more traditional lending practices which are known for excluding most of the poor from credit markets. It is, however, worth noting that lending institutions, especially those that employ the individual lending technology⁶, can hardly afford to issue collateral free loans because collateral serves as a powerful

⁶ Individual lending technology refers to the practice of giving loans to individual borrowers who are responsible for the repayment. It is different from group lending where the group as a whole is responsible for the repayment of every group member

incentive for borrowers to repay loans. Increasingly, though, “*institutions provide credit to the poor on the basis of social collateral through which borrowers’ reputation or the social networks to which they belong take the place of collateral*” (Navajas, 1999, p.2).

Institutions that employ the group lending technology, such as the Grameen bank, often use social collateral⁷ to replace physical collateral⁸ and indeed this helps much poorer people have access to credit markets. In these situations clients capitalise, not only on client lender relationships, but also on inter-client relationships which have the added benefit of increasing the social network of the clients, this is important considering networking is an important risk management mechanism for the poor (van Bastelaer, 2000; de Aghion and Morduch, 2000). Furthermore, in the case of group lending, clients stand to gain the multiple advantages of not having to pledge physical collateral, as well as being associated with a reliable lender, and expanding their social networks.

It is worth noting though that group lending has its own problems. For example, defaulters and bad risk clients can suffer perpetual exclusion and group members can pay for the transgressions of others (ibid). Furthermore, building-up and managing groups is costly, time consuming and tedious. As a result such microfinance institutions as BancoSol of Bolivia are increasingly resorting to individual lending for which collateral is one of the most effective ways of securing loans de (Aghion, B. A., and Morduch J., 2000).

⁷ Allegiance to the group or community, fear to lose trust and exclusion

⁸ Physical goods such as business premises, household utensils given as guarantee for loans

3.2.5 Above market interest rates

High or above market interest rates⁹ are charged in order to cover operational and administrative costs, and to ensure the sustainability of the lender (Littlefield, et al., 2003; Littlefield, 2004). Additionally they have a screening effect. They compel borrowers to take loans on the basis of expected returns and not in order to take advantage of subsidies (Brau and Woller, 2004). Put in Hulme and Mosley's (1996) words, "*financially sustainable institutions have high interest rates that serve as an automatic screener for borrowers with projects with low rates of return*" (p.32). Again charging above market rates ensures that only clients who are willing and can sustain long-term credit relationships enter the relationship hence increasing its quality.

It is, however, important to ensure that interest rates do not overburden the clients. If the loans are too costly, potential clients do not enter into relationships or exit the relationship shortly after entering into it. Worse still, the likelihood of default will increase with the cost of credit (Pagura, 2003).

3.2.6 Frequent monitoring

Frequent monitoring of borrowers is one way to prevent risks of default. Monitoring, not necessarily to check on the use to which funds are put, but mainly to check on whether there are changes in the borrower risk profile, is an important risk management tool. It helps lenders detect problems or changes in the risk profile early enough to take prompt corrective action (Norell, 2001). This monitoring is often done through site visits, both planned and spontaneous.

⁹ Market rates refers to official Interest rates charged in a particular market

3.2.7 Practical action against defaulting

Taking practical, fair and transparent action against defaults such as seizing the collateral pledged for the loans after all grace periods are over is used to underscore the institutions seriousness with repayment, hence discouraging borrowers from defaulting as a result of a simple unwillingness to repay (Churchill, 2000). In cases where signs of defaulting or actual defaulting take place, institutions should react promptly by paying a visit to the borrower. Depending on the reasons for the default, appropriate measures should then be taken. The quick response to arrears demonstrates the seriousness of the institutions' commitment to recovering the loan, especially to strategic defaulting (simple reluctance to repay) (Schmidt and Zeitinger, 1994). This practice also enhances the maintenance of client lender relationships by encouraging clients to take their relationship responsibilities seriously. Excluding defaulters from access to future loans is also considered to be an effective mechanism for encouraging repayment in *relationship lending* (Schmidt and Zeitinger, 1994).

3.2.8 Traditional vs. non-traditional risk management mechanisms

Although in *relationship lending* credit decisions are based primarily on the character and reliability of the clients, penalty and incentive mechanisms are used to make clients take their relationship responsibilities seriously (Churchill, 1999). In this regard, Churchill and Guérin (2005) argue, “*regardless of the clients’ poverty level [and the strength of the relationship] if the lenders do not take repayments seriously clients will not either*” (p. 10). As such, even in *relationship lending* risk and delinquency management mechanisms are important.

It is true that the more traditional risk reducing mechanisms do indeed influence lending in *relationship lending*, although in a less intense way than in traditional lending. The risk reducing mechanisms employed by many microfinance institutions - including the two case study institutions - become more flexible when the borrower has established a good reputation the credit relationship between the client and the lending institution has existed for a time. In short, the mechanisms are often bent to favour more established clients, hence the importance of a strong relationship to the client. It is for example pointed out that, “*In the case of BRI [Bank Rakyat Indonesia] a flexible definition of collateral gives staff a little leeway to increase loan sizes to reliable borrowers who may not be able to fully back loans with assets* (Christen et al. 1995, p.29, in: Khawari, 2004, p.16).

Furthermore, the physical collateral pledged in *relationship lending* has very little salvage value for the lender but sufficient personal value to borrowers who are expected to be unwilling to give it up, thus reinforcing their dedication to repay their loans. In the case of traditional lending and traditional risk reducing mechanisms, the collateral pledged has high salvage value to both the lender and the client.

Risk management mechanisms that resemble the more traditional mechanisms seem unavoidable in *relationship lending*. This is so because of the pressing need for lending institutions to deal with the problem of enforcing debt repayment and attain sustainability which is contingent on the ability of the institutions to reduce incidences of default. Put simply, Borrowers will usually not repay their debts if there are no incentives, positive or coercive, for them to do so (Churchill, 1999; Churchill and Guérin, 2005). As Reinke (no year) puts it,

Extending credit to individuals without collateral and without group pressure exposes the lender to greater vulnerability towards free-riding opportunism. Therefore, sufficient safeguards need to be applied to aid the selection of appropriate candidates and to enforce their compliance with rules and obligations (p.10).

Therefore, risk management mechanisms employed by microfinance institutions that use individual lending play an important part in helping institutions achieve high repayment rates. Of course such programmes tend to service much richer clients than those that use group lending (de Aghion and Morduch, 2000).

One tried and tested way of providing loans to those who have no assets to pledge is joint liability or solidarity groups, a method mostly associated with the Grameen Bank. It is for example argued that “*a large number of microfinance programmes-particularly those modelled on Grameen Bank are increasingly using group lending as an instrument that*

*helps reduce administration and monitoring costs, in addition to effectively providing collateral in the form of social capital*¹⁰”(Mainsah et al. 2004, p.19).

Group lending has its own problems. It is time consuming for both of borrowers and lenders. As such, assuming that borrowers value their time, group lending can be expensive for them. Furthermore, *“the time consuming nature of interaction between borrowers and credit officers limits the number who can be served by a credit officer”* (Reinke, no date, p.9). In this regard, lending to individuals can reduce the costs associated with building and sustaining group networks. However, lending to individuals compels lenders to resort to more traditional risk management instruments such as collateral which prevent most of the poor from entering credit markets.¹¹

An innovation which is increasingly being explored by BancoSol, for example, is combining both lending methods (Morduch, 1999). This provides clients with choice and helps institutions expand their borrower portfolios and include the very poor in their programmes considering that group lending is considered to be appropriate for poorer clients. Metrofund, another microfinance institution also combines individual and group lending. Frankiewicz (2001) points out the advantage of combining the two methods as he states that *“By providing both products, Metrofund offered its clients a choice, and in many cases, a stepping stone for growth. Micro-entrepreneurs with no collateral, no co-signers and/or a poor credit history could get them selves established with a group loan and later graduate to a one-on-one relationship with Metrofund through an individual loan”* (p.44).

¹⁰ Social capital serves as collateral because group members are pressurised to repay their loans for fear of losing credibility from members of the society in which they live since their actions (failure to repay) affects other members of the group who have to foot the bills or be excluded from the credit programme.

¹¹ Collateral is considered in literature as one of the risk management instrument most responsible for keeping the poor out of credit markets, see Gonzalez-Vega et al. 1996; Khawari, 2004

One can therefore conclude that combining group and individual lending is important for tackling the tensions between relationship lending and the use of risk management mechanisms that reflect the more traditional mechanisms. Additional substitutes for collateral include frequent repayment schedules which serve as a monitoring tool (Frankiewicz, 2001). Others include *“training requirements to credit rationing; some require that borrowers pledge savings as security; others tap local knowledge by requesting character certificates from local worthies who are compensated according to the performance of their flock”* (Reinke, no date, p.10).

3.3 Relationship building processes and dimensions

There is no universally accepted method for measuring the presence and strength of relationships in lending. Researchers, nonetheless, generally concur that if lenders grant credit to a client based on soft data (the character, and reputation of the client) obtained through interactions over a certain period and through various products, the lending is based on a relationship, often described as close long-term relationship between the lender and the client (Bharath, 2004; Berger and Udell, 2005; Boot, 2000; Cole et al., 2004). Other measures include: geographic proximity, high levels of social mobilisation, personal selling, emphasis on frequent communication and transparency,- sustainability of the institutions resulting from high levels of client loyalty and repayment rates-, high quality service and client satisfaction, exclusivity and the intensity of transactions. Below some relationship measures are discussed in detail.

3.3.1 Geographic proximity

Locating near the target group is considered a relationship proxy (Bharath, et al., 2004), for two main reasons: first, it gives clients (both potential and active), convenient access to the institution. This can serve as an incentive for the target group to enter and stay in relationships with the institutions. Second, loan officers can easily and cheaply visit potential clients to sell credit and other products, monitor loans and provide any technical assistance to needy clients, hence the closeness (Beck and da la Torre, 2004; Bharath, et al., 2004). Therefore locating branch officers near the homes and/or business premises of the target group is one important step in the establishment of client-lender relationship (ibid).

3.3.2 Personal marketing

The marketing strategy used by lenders is an important ingredient for building and sustaining client-lender relationships. Relationships often described as strong in the *relationship lending* literature are usually best described as personal (Wright, et al., 2003); as such a marketing strategy based on personal or one-to-one selling does not only serve to sell products and signal the lenders interest in building personal relationships with clients but also to give potential clients the confidence needed to enter credit relationships (Wright, et al., 2003).

A marketing strategy that is heavily dependent on the media and entails no contact with the target group is most likely to imply a distant relationship and as such is unsuitable for advertising programmes that target the poor. Another relationship dimension related to marketing is when clients help market lenders by referring their acquaintances to the lenders. This is usually considered a relationship proxy, because clients will normally work

for the lender in cases when the lender and the client are closely related (Ongena and Smith, 1998; 2001).

3.3.3 Transparency

Transparency¹² is both a prerequisite for the establishment of a strong and lasting relationship and a symptom of the existence of a strong relationship between the parties (Brusky and Fortuna, 2002). Institutions that exhibit high levels of transparency are more likely to win the loyalty of their clients hence the emergence of a strong relationship between the lenders and the clients (Brusky and Fortuna, 2002).

Just as lenders need accurate information about the potential borrowers in order to establish their creditworthiness and tailor products to their needs and capacity, potential clients need to understand very clearly the process of application and the costs and benefits thereof. Van Bastelaer (2000) argues that, *“a critical element of programmes’ success is the existence of trust between borrowers and lenders, which is in large part created and maintained by predictable and transparent applications of the lender’s rules”* (p.18). For this reason, high levels of transparency are used as relationship proxies.

3.3.4 Progressive lending

In addition to being a risk management mechanism, progressive lending is an effective mechanism for building and sustaining relationships in lending to micro and small businesses. When institutions start by granting small loans to their clients with the promise of larger loans in the future, provided the clients have a good repayment performance,

¹² Here transparency refers to clarity and fairness in the rules and practices of the institutions.

repetitive borrowing is certain to take place considering that there is high demand for credit among the poor. When this happens, a long-term relationship between the institutions and the clients is sure to be built and sustained. Therefore, through this risk management strategy, relationship building is enhanced. Both the institutions and the clients get to know each other better and as such become long-term relations (Pagura, 2003).

3.3.5 Frequent repayment schedules

Frequent repayment schedules help build and sustain relationships in micro lending. When clients have to make repayments frequently they engage in repetitive contact with the lender as they visit the branch office to make the payment or when loan officers visit the clients to collect repayments. This means that the lender gets to know the clients over time. In this way, long-term personalised relationships are established through repeated client-lender contact. Client loyalty and commitment to repay are fostered and risk is minimised at the same time as relationships grow in both quality and longevity (de Aghion and Morduch, 2000).

3.3.6 Frequent monitoring

In micro lending, lenders often check on their clients to see whether there is any change in their risk profiles and to assist them whenever necessary. In addition to being a risk management tool as described earlier, frequent monitoring helps keep the lender and the client in constant contact hence helping build and consolidate client-lender relationships (Pagura, 2003).

3.3.7 Sustainability

The sustainability of lenders or the prospect thereof, serves as an incentive for clients to enter long-term relationships with lenders and be serious about repayment. It is, for example, contended that *“if there is no guarantee that the lending relationship is going to last or rather that it is going to come to an end in the near future the borrowers are more likely to have little or no incentive to repay”* (Morduch, 1999, p.1583).

Furthermore, sustainability can result from a good rapport between the lenders and clients which leads to greater client loyalty, retention and positive repayment behaviour (Churchill, 2000; Pagura, 2003). In this regard, sustainability is an incentive for clients to enter lasting relationships with lenders and can be suggestive of the existence of close long-term relationship between lenders and clients. In most cases, when the relationship is beneficial to both parties, especially to the clients, borrowers stay with the programme, and their attitudes may implicitly or explicitly draw more borrowers into credit relationships with lending institutions (Churchill and Halpern, 2001) hence lowering risks of default and expanding borrower and loan portfolios (Bharath, et al., 2004).

3.3.8 The quality of service

Institutions often strive for quality of products and services in order to attract and retain clients in the credit relationship. Finaciera Calpia in Rural EL Salvador, for example, offers loans tailored to individual demands of their clients, in so doing making it ease for them to take advantage of productive opportunities (Navajas, 1999). The quality of products offered and how they are offered are used as relationship proxies; with highly personalised services resulting in the establishment of strong personal relationships on the one hand and

indicating the existence of close long-term relationships between clients and lenders on the other (Churchill, 2000).

Quality of services and fair terms and conditions are both prerequisites and an indication of the existence of strong relationship between clients and lenders. This includes fair pricing, realistic guarantee requirements, repayment schedules and terms to maturity (Pagura, 2003). Wood (1975), argues that “*the current quality of loans extended affects the strength of future demand*” (in: Ongena and Smith, 1998, p.11).

3.3.9 Positive incentives

Flexible ex-ante and ex-post contracting is instrumental for relationship building and sustenance (Ongena and Smith, 1998). In relationship lending, relationships are also built through giving clients incentives such as tax rebates, repayment holidays, loans with improved terms and conditions to well performing clients. The kind of treatment borrowers receive particularly in times of crisis is an important mechanism for building and sustaining close long-term relationship between the client and the lender. When clients are treated well and are rewarded for their good conduct they are more likely to be loyal and stay in the credit programme.

3.3.10 Exclusivity

One way that institutions build and maintain relationships with their clients is by attempting to become the sole provider of services, particularly loans (Berger, et al., 2001). This is attained by either providing services of higher quality and more flexible terms and conditions than competitors, or denying access to people with credit relationships with

other institutions. Normally, providing clients with better services and more flexible terms and conditions is the most used method for ensuring that clients stick to one institution. The idea is that clients satisfied with the institutions tend to be voluntarily loyal to that institution and purchase products exclusively from the particular institutions. When this happens it can be said that there exists a strong bond between the institution and the clients (Churchill, 2000; Churchill and Halpern, 2001).

3.3.11 Duration of transitions

A clear manifestation of permanence on the part of the lender is important for the establishment of strong client lender relationships of a long-term nature. Clients will most likely opt to enter a strong relationship with an institution that promises to be around and at the service of their clients for a long period of time. Therefore, the length of time an institution has provided and/or is willing to provide services to customers, and the duration and frequency with which clients purchase products from a particular lender, features in the literature along side scope (number of products sold or bought by a given client) as the two most important relationship measures (Ongena and Smith, 1998).

The longer the period and the more frequent the purchases the stronger the relationship (Elyasiani and Goldberg, 2004; Petersen and Rajan, 1994). A prior transaction between the lender and the client is also used a proxy (Dahiya et al., 2003; Schenone, 2004). This is consistent with the idea that a relationship starts when a client purchases a product the first time from the lender (Bharath, et al., 2004), and more so with the idea that the more beneficial the relationship is to both parties the longer they stay with each other (Pagura, 2003).

3.3.12 Scope of transactions

Scope or breadth of transactions refers to the number of products the particular lender provides to a client (Ongena and Smith 1998). The number of products or services lenders provide to particular clients is considered to be a determinant as well as a product of strong relationships (Cole, 1998). This signals the existence of mutual trust between the two parties. Clients purchase a broad range of services from the particular institution as a result of satisfaction with and loyalty to the institution, especially, in a competitive market (Churchill, 2000). By providing multiple services to a particular client, both the lender and the client get to know each other better and get involved in long-term relationships that may go beyond just credit to include savings, payment of utility bills and technical support (Degryse and Cayseele, 2000).

3.4 The importance of close long-term relationships

3.4.1 Benefits to the lender

The most celebrated benefit of close long-term relationships between lenders and clients is that such relationships help lenders market themselves and acquire information over time through direct contact with the potential borrowers and the community (Bharath, 2004) and use this information in their decisions about the availability of credit to the clients and the terms and conditions thereof (Degryse and Ongena, 2000; Chakravarty and Yilmazer, 2004). By developing a relationship with clients over time the lender can assess its clients profile and increase the precision of its risk estimation and as such minimise losses from default (Mishkin, 2004).

Strong client-lender relationships help foster demand and client loyalty to the institution (Elyasiani and Goldberg, 2004; Cole, 1998). They help the clients develop the confidence and skills for entering credit relationships and increase the precision with which lenders respond to the needs of the clients and consequently sales and repayment rates increase (Churchill, 1999; 2000; Bharath, 2004).

Strong client-lender relationships have been associated with a reduction in the costs of providing credit to the target group (Petersen and Rajan, 1995). The time and paper work needed for dealing with clients who have established relationships is reduced hence the reduction of lending and borrowing costs. Furthermore, the relationships “*can improve the monitoring of collateral...may render feasible for the bank to make loans that would not be profitable from a short-term perspective but may become profitable if the relationship with the borrower lasts long enough*” (Ferri et al., 2001, p.6).

Strong client-lender relationships can help lenders retain clients and further enhance sustainability because,

Typically, retained customers are the ones with extensive credit history and who are accessing larger, higher value loans; whereas new customers require induction training...MFIs typically break even on a customer only after the fourth or fifth loan (Wright, 1997, p.2).

Furthermore, the relationships can help lenders expand their outreach with reduced risks. When clients are satisfied with the services of the institutions and the relationship established between them, they not only stick to the programme but spread word in their communities about the lenders and encourage their peers to join in, especially if they feel they are getting a good deal from a serious institution committed to serving the community in the long-term (Gonzalez-Vega, et al., 1996). When this happens, borrower portfolio

increases and institutions take advantage of economies of scale and attain cost effectiveness and sustainability (Cole et al., 2004).

3.4.2 Benefits to clients - both potential and active

Close relationships between lenders and the target group can help draw risk averse clients who would otherwise benefit from micro loans into credit relationships with formal institutions. This is particularly important considering that, “...*although individuals are better judges of their situations, the fears [of failure] may be more about confidence than reality*” (Hashemi et al., 2006, p.1). The importance of relationships in helping deal with lack of confidence or risk aversion is also emphasised by Chakravarty and Yilmazer (2005) who contend that, “...*relationship measures are most important in increasing the probability of applying for a loan ...*” (p.3).

Close long-term relationships are often associated with larger loan sizes (Petersen and Rajan, 1995; Berger and Udell, 2002). In micro-lending, loan sizes are often small, not because borrowers do not want large loans but because lenders are not certain about the client’s capacity and willingness to repay (Ghosh and Ray, 1996). As such, lenders would rather issue small loans in the beginning, and, as the relationship between them matures, larger loans are issued (Boot and Thakor, 1994; Berger and Udell, 2005); So, clients who stay longer and take more than one loan benefit from larger loans.

Strong long-term relationships between clients and lenders affect repayment cycles and terms to maturity. In micro-lending, repayment is often as frequent as weekly or biweekly and terms to maturity short, especially at the early stages of the credit relationship (Ledgerwood, 2001; Schmidt and Zeiting, 1994). However, as the client demonstrates

loyalty through punctual repayment over a period of time, in which case the reputation and ability of the client to repay and a relationship is established, repayment tends to be less frequent, and terms to maturity become longer (Berger and Udell, 1995, 2002; Schmidt and Zeitinger, 1994).

Client-lender relationships are associated with interest rates, albeit in an inconclusive relationship. Some argue that borrowers with longer relationships with lenders pay lower rates as the relationship matures (Berger and Udell, 1995; Boot and Thakor, 1994). Others contend that relationships have no bearing on interest rates (Petersen and Rajan, 1994; Chakravarty and Yilmazer, 2005). Yet others contend that interest rates in fact increase with the duration of the relationship (Ferri et al., 2001; Sharp, 1990; Degryse and Cayseele, 2000). Interest rates are only a fraction of the total costs of borrowing. Other costs arise from the steps required to secure a loan. Strong long-term relationships are said to lead to increased simplicity and reduced red tape in lending and in so doing reduce costs to both borrowers and lenders (Gonzalez-Vega et al., 1996; Ongena and Smith, 1998).

The relationship between collateral and strong client-lender relationships is also inconclusive. Boot and Thakor (1994) argue that the duration of a bank-borrower relationship has effects on collateral. They argue that borrowers pledge collateral in the early stages of the relationship, and do not need to pledge collateral later on (Berger and Udell, 1992, 1995; Boot and Thakor, 1994). It is, however, also argued that collateral is still pledged when long-term relationships exist (Sharpe, 1990). More important, however, is the fact that strong relationships help lenders monitor the collateral pledged more easily than when the lender and the clients are distant both physically and 'emotionally' (Boot, 2000). This is important, bearing in mind that if the collateral - which initially has little

resale value - can not be monitored, borrowers may further depreciate it through misuse, making it even more difficult for lenders to extend credit to the target group (Boot, 2000).

Ex-post contract negotiations are connected with strong client-lender relationships. It is argued that in the presence of strong relationships clients benefit from the possibility of renegotiating terms and conditions and refinancing in times of crisis especially when arrears result from factors beyond the borrower's control (Ferri, et al., 2001). Lenders retain these options in credit programmes in order to build a reputation of being strict but fair (Schmidt and Zeitinger, 1994).

Clients have quicker and greater access to credit when they are engaged in a relationship with lenders. Put in Chakravarty and Yilmazer's (2005) words, "*...relationship measures are most important in increasing the probability of applying for a loan and lowering the probability of being rejected for a loan*" (p.3). When institutions can relatively easily obtain information about the potential clients through a close long-term relationship with the target group, they can more readily screen and identify good risk borrowers, provide credit, and monitor them (Berger and Udell 1995). When this happens more and more people can be drawn into the credit relationship (Streb, et al., 2002). Moreover, improvements in loan terms and conditions resulting from relationship often mean lower-cost credit to the target group, hence an increase in access (Petersen and Rajan, 1994, 1995).

It is, therefore, evident from the literature that, generally, both clients and lenders stand to benefit from close long-terms relationships. However, Sharp (1990) and Rauterkus (2005) also show that relationships may not always be beneficial in that lenders may hold up clients and extract excessive rents from this capture, in the form of high interest rates

charged later in the relationship when the client is already intimately involved with the institutions (Nalukenge, 2003). Furthermore, clients may, due to the hold up problem, fail to take advantage of the services of intermediaries with better terms and conditions (Thakor, 2000); this is particularly so in less competitive markets.

On the other hand, lenders may invest in establishing strong bonds with the clients by making concessions such as charging lower interest rates and fee exemptions in the early stages of the relationship with the hope of getting compensation as the relationship matures, only to see the clients drop out before such compensation is attained (Ongena and Smith, 2000). Additionally the realisation by clients that terms and conditions can be renegotiated ex-post may induce them to irresponsible conduct¹³ (Ferri et al., 2001).

In sum, the literature reviewed in the ambit of this research shows that financial intermediaries that deal with the target group are increasingly, at least in principle, depending on the establishment of close long-term relationships with their target group in order to reduce asymmetric information and contract enforcement problems that have traditionally adversely affected lending to the poor. The clients on the other hand depend on such relationships to gain greater access to credit and other services they can hardly get from traditional commercial lenders.

It is worth noting though that close long-term relationships are not panaceas to problems that affect financial markets especially those dealing with the target group. As such, most of the features of traditional lending e.g. requiring borrowers to pledge collateral are still evident in relationship lending. The conclusion drawn therefore is that lending to the target

¹³ Such as deliberately missing a repayment date

group has not yet been fully done based on relationships alone or in the main, and lenders are still risk averse. The result is the limited outreach reported worldwide and high proportions of the poor not yet served by the formal microfinance industry.

4. PROFILE OF THE CASE STUDY INSTITUTIONS AND ANALYSIS OF THE LENDING TECHNOLOGY THEY EMPLOY VIS À VIS CLIENT LENDER RELATIONSHIPS

In this chapter, a brief profile of the case study institutions A and B and the lending technology they employ are presented and discussed. The two institutions have similar missions and employ a similar lending technology, with minor differences. The differences do not affect the study in any significant way if overlooked; therefore their profiles and the lending technologies are jointly presented and discussed.

4.1 Profile of the Institutions

The two institutions are regulated private microfinance institutions in operation for just over six (6) years. Their mission is to provide financial services to micro, small and medium-sized enterprises, and to ensure sustainable returns on their investments to shareholders.

They operate in urban areas and are strategically located near both the homes and business premises of the target group. They are located within walking distances of some of the largest informal markets and low-income neighbourhoods in the city of Beira. The strategic location of the branches of both institutions results from the acknowledgement that locating near the target group is convenient for both the institutions and the target group. This is consistent with Beck and de la Torre, (2004) and Bharath, et al., (2004) who consider geographic proximity as an important aspect in microfinance, since it makes it easy for both lenders and clients to access each other, and in so doing save a great deal of time and money that would have been used for transport, especially in cases where the

lender and the client can actually walk to one another¹⁴.

The institutions employ the commercial approach to lending, use the non-conventional lending technology based on individual lending and offer a range of loans to micro-entrepreneurs, salaried workers, and SMEs- which include start up and working capital, consumer and house loans. Institution B has focused on credit alone for five (5) of the six (6) years of its operation as a regulated microfinance institution. The other has been offering a range of products that includes loans, accounts- including, current, cheque, term deposit and savings accounts-, and services such as Western Union services, payment of utility bills and foreign currency exchange.¹⁵

The institutions depend on investments from their owners (shareholders), revenues from their operations and loans from other banks for their operations. They charge interest rates in the range of six percent (6%) and six point five percent (6.5%) a month and five percent (5%) fees for all successful applications.¹⁶ The financial indicators of institutions A are not up to standard. Despite gains in the number of clients, high repayment rates and levels of operational self-sufficiency, profit margins have been negative throughout except for the year 2004.¹⁷ Various reasons have been given for this, they include: the macroeconomic environment, inflation and exchange rate fluctuations in the country which affect the institution because most of its debts are paid in USD yet their business in the country is done in the local currency¹⁸. However, growing borrower and loan portfolios and ninety-

¹⁴ Client interviewed in the ambit of the research have repeatedly highlighted this advantage. The research confirms the distances having undertaken some interview at the homes of the respondents

¹⁵ This information was given by the management of the institutions and can be found in the annual reports of the institutions

¹⁶ From these figures we get a nominal annual rate of 78%. These rates are very high when considering that the market interest rates charged by commercial banks in Mozambique is in the range of 25 % per annum.

¹⁷ see appendix II

¹⁸ Interview with Boris senior officer for institution A

seven percent (97%) repayment rates, show that the institution has a promising future¹⁹. Institution B has generally done well, although with some oscillations; it has had positive profit margins and default rates below three percent (3%) since the year 2000, surprisingly it is the institution with fewer products and less clients than the other.²⁰

The two institutions have registered gains in terms of outreach since they began operations. They have registered an expansion in their borrower portfolios. As of the year ending 2005 they jointly served twenty-two thousand nine hundred and sixty four (22, 964) clients countrywide.²¹ Overall, the number of clients served by these institutions in Beira is small; out of an estimated thirty-thousand (30 000) potential clients²² and several more credit constrained people, less than ten thousand (10 000) have access to formal credit, with the two institutions jointly serving just over five thousand (5000) clients²³.

4.1.1 The clients

Most of the micro-loan clients of the two institutions are micro-entrepreneurs, mainly self-employed. They largely operate within the informal economy, and the majority are involved in various forms of trading, varying from market vending, tailoring, carpentry, tin-smithing, baking, bicycle repairing, general dealing, hair dressing. These clients usually use the loans for working capital and sometimes to diversify their activities by starting new ventures, although loans are primarily given for financing existing businesses.²⁴

¹⁹ see appendices I and II

²⁰ appendices I and II

²¹ see appendices I and III

²² These figures are estimates provided by one respondent from within the institutions. They coincided with the estimates provided by a respondent from the other institutions. Unfortunately non-of the respondents provided the basis for the figures hence putting their reliability in question.

²³ The number is obtained from the records of each institution in their Beira branches, Institutions A has the bigger number 2.956, institution B 1. 983 clients (these are 2005 figures)

²⁴ Reflected by the requirement that applicant must have a business than has been running for at least 12 months

The management of both institutions describe their clientele as belonging to low-income segments of the Mozambican society. A few factors attest to this claim; these include: high incidences of loans below USD\$300 and average loan balances of less than USD\$900²⁵. Furthermore, the near fifty percent (50%) average number of women borrowers can also serve as an indicator of reaching the poor, especially considering that women have traditionally suffered deep and prolonged social and economic deprivation and are still considered to constitute the majority of the poor. UNDP (1999) reported that seventy percent (70%) of the 1.3 billion people living on less than a dollar a day are women. As such the greater the number of women in borrower portfolios the more it is said that the lender is reaching the poor.

However, considering that there is a considerable number of women who are relatively well off, especially in urban settings, and that the institutions could be serving such women more than the poor, using the number of women in borrower portfolios as a proxy for poverty outreach is questionable; unless actual poverty assessments of the women involved proves that they are in fact poor.

On the same note, although the clientele served by the two institutions, belongs to the low-income²⁶ segment of the Mozambican society they are the relatively better-off in the broader category of the poor²⁷. They tend to belong to households that can meet their daily needs, have access to primary education and basic health services, and have some assets. They enjoy relatively stable incomes, have more diverse sources of income and are well connected with suppliers, especially shop owners. This allows them to manage repayment

²⁵ see appendices I and III

²⁶ Going by the average loan sizes which are relatively low; See appendices I and III

²⁷ Considering the entry requirements collateral and 12 months business experience

even when faced with small crises. However, most of them hardly qualify for credit with traditional commercial banks, since they generally run very small business with no 'hard information' i.e. financial records and traditionally bankable collateral (houses and land titles). For this reason, they resort to either microfinance institutions or informal money lenders.²⁸

4.1.2 Entry requirements

To be eligible for loans, applicants are required to be at least 21 years of age, have a running and successful micro business for at least twelve (12) months, have a good reputation in the community, and have no arrears with other institutions. Required documents include: identity card or a passport or proof of application for the identity card and proof of residence.

Respondents consider the overall eligibility criteria to be reasonable, however, the co-signer and the 12 months business experience requirements are the two most unpopular requirements, followed by collateral which not only bars many from entering credit relationships but also limits the loan sizes for those who qualify. This is especially the case as they have to be able to pledge collateral worth 120% of the loan they are granted.

Respondents claim that it is difficult to convince people to be co-signers; and that the twelve (12) months business experience is too much. Respondents from within the institutions have, however, said that these requirements are flexible and that individual situations are taken into consideration. For example, when the applicant has a potentially profitable venture and is of high repute in the community, credit granting decisions can be

²⁸ Interview with Luisa, Loan officer for institution B

made in their favour even in the absence of some of the requirements²⁹. On the whole, however, these requirements prevent most credit constrained people from accessing credit, despite the fact that on the surface they may appear to be within the reach of the majority of the credit constrained poor³⁰.

4.2 The lending technology used by the two institutions

The lending technology used by the two case study institutions is a copycat of the non-conventional lending technology, also called *relationship lending*, known to hinge on strong long-term client- lender relationships. Loan granting decisions are, to a large extent, based on what Berger and Udell (2002) call “*soft information*” which includes estimates of the income of the applicants, their character and reliability. Loans are secured through non-traditional collateral, co-signers, and other mechanisms, including: small initial loans, frequent monitoring and repayment cycles³¹.

4.2.1 Organisational structure

Consistent with *relationship lending* literature (e.g. Berger and Udell, 2002) and the non-conventional lending technology employed by the two institutions, the organisational structure of both the institutions allows loan officers some deal of authority and discretion; they bear full responsibility for the institutions’ relationship with the clients throughout the entire life of the loans; including analysis and screening, disbursement, monitoring and enforcement and repayment. Loan officers are, therefore, recruited and trained on the basis of both the technical skills required to manage loan portfolios and the public relations skills

²⁹ Loan officers of both institutions

³⁰ 65% of the respondents have said that the entry requirements especially collateral and co-signers are responsible for keeping most of the poor out of credit programmes

³¹ This information was provided by loan officers and the management of both institutions

necessary for recruiting and motivating borrowers, and for managing the inherent relationships.³²

Although the loan officers have a great deal of discretion when it comes to granting and renegotiating loans, they are accountable to and are monitored by a credit committee which takes most of the final decisions after taking into account the recommendations of the loan officer³³. Furthermore, the credit analysis they undertake is largely standardised, and the decision about whether or not the loan application will be approved is taken in the last instance by a credit committee to which the loan officer has to present and justify the data collected from the credit analysis and the recommendation for or against the application. This helps to make the data obtained more objective and also helps monitor the actions of the loan officers themselves³⁴. Loan officers have performance bonuses which are in most cases higher than their base salaries. These serve as incentives for them to recommend clients on the basis of merit and not favouritism.³⁵

4.2.2 Marketing strategy

The main marketing strategy used by the two institutions hinges on personal selling. It is through personal selling that institutions make initial contact with the target group. Loan officers go out in the field often in the markets and low-income neighbourhoods to create awareness among the target group about the institutions and the products and services they offer; large scale promotional campaigns are also carried out in the markets and

³² Interview with Carlos, senior officer of institution B

³³ Interview with Carlos, senior officer of institution B

³⁴ This is consistent with Navajas (1999) who highlights the importance of discipline and enforcement as requisites for the success of credit programmes based on reputation and credibility (p.16). See also Schmidt and Zeitinger (1994, p. 130).

³⁵ Interview with Carlos, senior officer of institution B. NB: The interview with Boris, senior officer of institution “A” shows that the two institutions have a similar practice

neighbourhoods around the city.³⁶ The institutions are well known among the target group and have a reputation of serving poorer clients than those served by the traditional commercial banks³⁷.

4.2.3 The entry process

The actual process begins when a potential client shows interest in taking loans with either one of the institutions. Interested individuals are advised to contact a loan officer of the relevant institution in the field or at the branch office where a loan officer is assigned to guide them through the application process. On the first contact for the discussions about the loan, the loan officer holds a serious but friendly talk with the prospective applicants. In the talk, the loan officer reiterates that the institution is a profit oriented institution which depends on the revenues from lending activities to continue in the business. They make it clear to the applicants that fees and interest rates are charged for all loans, and that they require clients to pledge collateral which will be seized if borrowers do not repay the loan.³⁸

They further explain to the potential applicants the necessity for establishing a reputation of punctual repayment for the sake of future access to credit, especially in time of emergency. In sum, the conversation emphasises the range of products offered, the simplicity of the process when potential clients cooperate by revealing truthful information and the benefits of having a long-term relationship with a permanent lender. Furthermore, the risks of default to both the institutions and the client are explained³⁹. It is worth noting the loan officer's emphasis on future credit transactions, which underscores the institutions

³⁶ Information from loan officers of both institutions

³⁷ Information from clients and non-clients interviewed

³⁸ Information from the senior officers and loan officers from both institutions

³⁹ Information from management and loan officers of both institutions

interest in long-term relationships with the clients.

In the next step, the loan officer asks the prospective applicant about the reasons for applying for the loan and asks questions related to the business and the household of the potential client. The applicants must be able to show that they have a successful business or one with the potential of becoming successful given the required injection of capital, and that they have alternative ways of repaying the loan in case the business fails or does not produce enough returns to meet repayment obligations; that they have enough household goods that can be used as collateral and that they have no delinquent loans elsewhere. Institutions have access to a list of reported defaulters produced by the central bank with the collaboration of formal lending institutions that have to report defaulters⁴⁰.

The information obtained from the talk is registered for a comparison with what the loan officer will find on site i.e. at the home and business premises of the applicant. This is considered an important element in the process of establishing the honesty and reliability of the potential client. Loan officers interviewed in the ambit of this report said that these talks are informal screening mechanisms and that normally about forty percent (40%) of would be applicants desist after the talk⁴¹. This is a considerably large number considering that at this stage the potential applicants have ruled themselves out and the institutions themselves will exclude many more when the actual credit analysis is carried out and the results are submitted to the credit committee.

The high levels of premature dropouts before the institutions actually assess the potential clients shows that many people wish to have credit relationships with formal lenders; it

⁴⁰ Information from the senior officers of both institutions

⁴¹ Interview with Miguel, loan officer for institutions A

also shows that the entry constraints are a bit high for the target group; it further shows that institutions are mindful of the risk of clients, hence the screening.

When, after the initial credit talk between the loan officer and the potential applicant, the latter feels they stand a chance and the loan officer concurs, the next step is to undertake a credit analysis to establish the creditworthiness of the applicant. The loan officer obtains the data needed to carry out a comprehensive cash flow analysis by visiting the applicant's business premises and household to understand the true nature of the prospective borrowers' economic and social situation. The credit analysis focuses strongly on the prospective borrowers' ability and capacity to repay, by striving to make a realistic calculation of the overall income and cash flows of prospective borrowers' household and micro-enterprise⁴².

The credit analysis is also aimed at determining the applicants' character and personality to establish their willingness to repay. The consistency with which the borrower and the family explain and support their reasons for applying for a loan and the cash flow analysis carried out by the loan officer determine whether the application is accepted or rejected. Often other people close to the applicant are consulted, especially if they are active borrowers, about the character of the applicant⁴³.

A respondent underlined the importance of initial screening in the following terms,

...if we do not get it right from the beginning we might be doomed. You know that everyone will be happy to get money from somebody else, especially from institutions, even when they know very well that they are not able to put it into productive use and generate enough returns to keep up with their repayment obligations; when we fail to

⁴² Interview with Miguel, loan officer for institution A

⁴³ *ibid*

screen these kinds of people in the beginning we face risks of default, which makes our business less profitable and not worth doing. For this reason we thoroughly screen applicants, in the beginning and throughout the life cycle of the loan⁴⁴.

In addition to helping establish the creditworthiness (ability and willingness of potential borrowers' to repay loans) the credit analysis makes it possible to determine the potential credit needs of small and micro enterprises and match loan sizes, repayment cycles and amounts, and terms to maturity to the credit needs and repayment capacity of the borrower, thus preventing the borrower from being over or under funded which can lead to default. This was captured by a respondent in the following terms

...our analysis also helps us understand the individual credit needs of the clients and the environment in which they do their businesses so that we match loan sizes, terms and conditions with their exact needs and capabilities⁴⁵.

It is therefore evident that credit analysis and screening processes play important roles in both the selection of clients and the identification of the specific needs of the clients. This is even more important when considering that meeting the specific needs of individual clients is important for fostering their loyalty to the lenders and as such ensure repayment.

4.2.4 Loan granting and rejection process

Once the credit analysis is concluded (in many cases it is concluded on the same day) the loan officer puts together all the necessary documents submitted by the applicant and the results from the credit analysis carried out by the loan officer and submits it together with recommendations to a committee which decides on whether to extend credit to the applicant or not. Normally the loan officer hands over the application file to the committee when the applicant meets the minimum prerequisites for qualifying for a loan.

⁴⁴ Interview with Carlos, senior officer for institution B

⁴⁵ Interview with Rosa, loan officer for institution B

In cases where the applicant does not meet the requirements for eligibility the loan officer has the authority to turn down the application and explain the reasons for the decision and provide advice and encouragement to improve the application in the future. This is important because it gives them the hope of joining the institution someday and encourages them to work to this end. According to one loan officer,

When an application is rejected we try to communicate the rejection in a friendly way often giving the responsibility for the rejection to the credit committee to avoid any personal hard feelings and make it easy for them to approach us in the future⁴⁶.

The transparency displayed by the lenders is impressive. Clients appreciate this because they enter a credit relationship knowing exactly what is expected of them and what they should expect from the institutions⁴⁷. Qualifying applicants are contacted by the loan officer to be informed about the loan decision and the exact terms and conditions for the loan. They are given charts to show the payment plans available and the corresponding instalment amounts to choose from- how much they have to pay and when, what constitutes the principal, the interest and fee due dates, and the penalties involved in the case of default. They are also informed about the need to develop a reputation of using credit productively and punctual repayment in order to benefit from future credit opportunities at improved terms and conditions. The benefits include: quick disbursements, larger loans, longer terms to maturity, flexible repayment schedules, rescheduling and refinancing during crisis.

When loans are granted, first time borrowers get smaller loans and it takes them a maximum of five (5) days for a disbursement to take place, especially when there is no prior relationship between the borrowers and the institutions. First time borrowers with

⁴⁶ Interview with Garicai, loan officer for institution A

⁴⁷ Interview with Wadzanai, client for institution A. NB: her assertion is seconded by all interviewees among the clients.

well maintained fixed or current accounts can have a decisions made in their favour in a maximum of three (3) days. Repeat borrowers with a reputation of timely repayments and well maintained accounts can have their loans granted in less than an hour⁴⁸. This is consistent with the ideas of Dahiya et al., (2003); Schenone, (2004) and Chakravarty and Yilmazer, (2005), who say that the existence of a relationship prior to an application for a loan increases the chances of applicants to get a loan.

4.3 Contract terms and conditions

4.3.1 Loan sizes and repayment schedules

Loan sizes vary from US\$ 150 to US\$ 4000. The decision on the amount of the loan is based not solely on the request made by the client but principally on the overall income of the applicant i.e. both the potential returns on the investment and the household income. Normally initial loans are small but eventually increase with subsequent applications, but the increase is often contingent on the capacity to repay as perceived by the institutions and the availability of corresponding collateral⁴⁹. Loan sizes are a contentious issue. Borrowers want more than the institutions are prepared to give; sixty percent (60%) of the interviewees expressed this feeling. Thirty percent (30%) of the clients interviewed have said that they usually have to borrow from other people to top up in order to make new investments and diversify their sources of income or expand the existing enterprises.

The lenders, however, acknowledge that the institutions are fair in their decisions because they demonstrate to the clients how they reach the amount they decide to give them and

⁴⁸ Interview with Rose, loan officer for institution B

⁴⁹ Interviews with the senior officers and loan officers of both institutions reveal that both institutions have these requirements

that it is often enough for financing existing business but not for expanding them or exploring other opportunities⁵⁰. The institutions acknowledge that disbursing larger loan amounts is beneficial to the institutions in terms of administrative costs. Nevertheless the institutions themselves are adamant that it would be unwise to give more than the cash flow analysis and the judgements of the officers and the committee conclude should be the right amount to grant. As a respondent put it

we can not give larger loans on the basis of a relationship alone. The results of the credit analysis our loan officers undertake are important determinants of the size of the loan; coincidentally our clients improve their cash flows with their first few loans and often they get larger loans⁵¹.

From this response it is clear that although relationships are important in credit decisions, the ability of clients to make profitable investments and increase their incomes are equally, if not more, important than the relationship alone. Therefore, those who have access to larger loans are those clients who progressively increase their incomes, and not necessarily those who have a close relationship with the institutions.

The institutions make their disbursements to clients in one-off cash payments. Repayment is made on weekly, biweekly and monthly bases. Normally clients are given choices in terms of repayment cycles. This is especially true of repeat borrowers. Terms to maturity range from four (4) to twenty four (24) months; they are normally kept as short as possible for first time borrowers⁵².

Clients usually prefer small instalment repayments to extend over long periods rather than larger instalment with short terms to maturity, especially monthly repayments over a

⁵⁰ This is generally the case with those clients who have weak assets base and as such do not have collateral valuable enough to get larger loans

⁵¹ Interview with Carlos, senior officer institution B

⁵² Interview with Luisa, loan officer for institution B

twenty-four (24) months period⁵³. Clients have the choice to adjust their repayment plans from their initial choices; a price is often paid for these operations - especially if it means extending terms to maturity; it costs less to shorten the terms to maturity (when a client feels he/she wants to pay all dues before the loan is due)⁵⁴.

4.3.2 Collateral

Collateral is required in all instances. Applicants must have property with an estimated value of 120% of the amount requested⁵⁵. This is contrary to Boot and Thakor (1994) who associates the existence of a close long-term relationship with a decrease in the amount of collateral required. In fact, considering that the value of collateral required by the two institutions is a constant 120%, the value of the collateral pledged in real terms increases with the length of the relationship, given that in some instances the more the relationships lasts the higher the loan sizes. Consistent with Schmidt and Zeitinger (1994) and Krahnen (2000), assets that are acceptable as collateral include appliances and furniture, inventory, the business premise itself and anything that is valuable to the borrower but not necessarily to the institution⁵⁶.

It is worth noting that although assets required as collateral in the microfinance industry Krahnen (2000) are said to be generally within the reach of the target group (Schmidt and Zeitinger, 1994; Krahnen (2000), this is not quite the case in Beira, given the levels of poverty there. Just to illustrate, minimum wages for both public and private sectors are lower than USD\$100 a month, the majority of the population lives in informal settlements with no electricity, piped water and other basic services. Even a salaried civil servant may

⁵³ Interview with clients

⁵⁴ Interview with loan officers, information confirmed by clients especially those for institution A

⁵⁵ Interviews with management and loan officers

⁵⁶ Information from senior officers and loan officers. NB clients find collateral requirements constraining

not have a TV set or a refrigerator or anything that can be accepted even as non-traditional collateral. Therefore, collateral is a constraining requirement for most of the poor who would have wished to have access to credit.

4.3.3 Fees and interest rates

The institutions charge monthly interest rates of between 6 and 6.5% per month. Loans above 50000 MZM (USD\$ 1940) pay between 0.25% and 0.5% less interest than those below this amount. Furthermore, all successful applicants pay a fee of 5% of the loan granted⁵⁷. The rates charged by the institutions, are equivalent to annual nominal rates of up to 78%; they seem exorbitant compared with the market rate for Mozambique, which is at 25% per annum (BoM, Banco de Moçambique, 2006).

However, financial intermediation theory considers these rates to be common in micro credit markets because the cost of supply is quite high and as such institutions charge high rates to cover these costs (CGAP, 2003). The rates charged in Mozambique are not far from those charged, in East Asia where nominal interest rates are said to be up to seventy (70%) percent, with effective rates being much higher due to commissions and fees (Fernando, 2006).

Interestingly, fifty-five percent (55%) of the twenty (20) interviewees seemed unconcerned by the fact that interest rates are this high. Theory and previous empirical studies explain this seeming lack of concern with high interest rates as resulting from the target group's preoccupation with quick and convenient access to credit (Ghosh and Ray, 1996, CGAP, 2003).

⁵⁷ Information from senior officers of the institutions

Although the majority of the interviewed seemed less concerned with the amount of interest rates paid, a substantial number, i.e. forty-five percent (45%) found it to be a bit too high. Seven (7) of the nine (9) respondents who seemed concerned by the far above market interest rates, run larger enterprises than the other two (2) and the eleven (11) of the respondents who seemed less concerned about the high interest rates. In addition to implying that the smaller the enterprise of the client the less concerned with the cost of credit the proprietor, these findings also show that interest rates do in fact matter for clients, the problem is that they can do little about them, especially because informal lenders charge annual interest rates well above 100%⁵⁸.

In banking, lending fees and interest rates constitute just a part of the total costs involved. There are other costs related with the bureaucratic exigencies which can increase the costs of borrowing. In the case of the two institutions transport costs, for example, are insignificant given the geographic proximity of the institutions to both the work place and homes of the clients. Most of the respondents are appreciative of the location of the institutions and confirmed that visits to the institutions cost them nothing in monetary terms and cost them very little time. When asked what they visited the institutions most for, one respondent, in common with 16 others, said,

to deposit our takings mostly at the end of the day or any takings that are to high to be kept at the business premises because there are a lot of thieves here⁵⁹.

This respondent shows that clients not only purchase credit products but also use the savings facilities with their respective institutions. This further shows that the institutions

⁵⁸ This information was given by most of the clients and was confirmed by the management of the two case study institutions.

⁵⁹ Interview with Tatenda, client for institution A

and their clients are related beyond just credit but other services as well. With clients using the savings facility or products a long-term relationship between the lender and the clients is established. Furthermore, knowing that their money is kept in the bank, the client is more likely to behave in such a manner so as to ensure the longevity and sustainability of the bank lest they lose their savings.

4.4 Risk and delinquency management

Both institutions are conscious about the need to make sure that their lending practices do not lead to over indebtedness among the target group and as such to their failure to attain self-sufficiency and remain in operation. For this reason, several risk and delinquency mechanisms are employed by the institutions; these include but are not necessarily limited to:

4.4.1 Thorough initial screening and communication

As has been discussed earlier, the institutions start with a thorough screening process. Collateral, the requirement of a co-signer, frequent repayment schedules, interest rates and frequent monitoring are used as risk management tools, in the same manner described in the literature review chapter.

The institutions also rely on open and frequent communication with the clients about the need to meet their repayment obligations. They emphasise the benefits of having a continuous access to credit, increasingly larger loans, and longer terms to maturity and greater choice in repayment plans. In cases of difficulties, clients are encouraged to report any difficulties that might lead to failure in repayment before the loan is due so that

contingency plans are jointly drawn by the clients and the loan officers⁶⁰.

4.4.2 Frequent monitoring

Once applicants actually enter a credit relationship with anyone of the institutions, loan officers often kept in touch with the clients, mainly through occasional visits. Generally, such visits are not programmed. Under normal conditions the visit is simply a short friendly stopover, which can be quite informative for the loan officer. According to loan officers interviewed in the ambit of this research these visits help monitor the changes in the risk profile of the clients. Furthermore, they serve as a reminder to the clients about their obligations to the institutions. As one loan officer put it,

by just seeing us they may remember that the date for the repayment of their debt is near, usually we visit them towards the end of the month when most payments are nearly due. It is also during these visits that we help clients with how to improve their business, often in response to their request; we normally just ask how their businesses are going and if they need any assistance, and when it is within our capacity we help free of charge⁶¹.

As is evident from the above interview extract, monitoring of clients is not only a risk management mechanisms but a vehicle through which lenders keep in touch with their clients to offer them any necessary assistance which lenders can afford.

4.4.3 Practical and rapid reaction to arrears

In the case of default or the likelihood thereof, loan officers visit the clients a day after the due date to establish the causes of the failure to repay. When failure to repay is a result of factors beyond the clients' control, depending on the clients' reputation and credit histories, rescheduling of repayment plans and even refinancing are possible. In the main,

⁶⁰ Interview with Boris, senior officer for institution A

⁶¹ Interview with Miguel, loan officer for institution A

however, defaulters are given a period of sixty (60) days to settle the debt.

Failure to do so results in the seizure of property which is retained by the institution for a further sixty days (60); during this period they can reclaim their property upon the settlement of all debt and be readmitted at a later stage. However, failure to settle the debt during the grace period means the property is auctioned out, and the client is black listed.⁶²

If failure to repay results from a simple unwillingness to repay or from irresponsible management of the enterprise the defaulters are given a period of thirty (30) days to settle the debt. If they fail to do this, all property pledged as collateral is forfeited and kept in the warehouse of the institutions for a period of thirty (30) days⁶³. During this period the clients can get their goods if they can repay their debt, and are given the opportunity to rejoin the programme. Failure to settle all outstanding debt in this period means the goods are auctioned and the defaulter is denied future access to credit, at a great loss to both the lender and the defaulter. According to loan officers interviewed, this practice is less frequent on the whole since most borrowers manage to repay within the grace periods.

Unlike institution A, institution B is more strict in reacting to arrears. Loan officers visit the clients a day after a repayment date is skipped notifying the client to repay within 30 days; failure to meet this deadline result in the seizer of collateral pledged and subsequent auctioning. The client does not have as long a grace period as the clients of institution A. Asked about why institution B is so strict when it comes to missing repayment dates, a senior officer in the institution had this to say:

We have had a bad experience with defaulting during the period when we operated as a not

⁶² Ibid

⁶³ This operation is done by officers from the institutions and the police is involved in case of resistance by the defaulter

for profit institution. We therefore have the responsibility to show to our clients that we are no longer the “charity” institution we used to be, by being quick at responding to arrears. This cultivates in our clients the culture of repaying debt and this is working⁶⁴.

By and large, the two institutions seem apt for the great challenge of providing credit and other services to a clientele that has been excluded from the formal credit markets. They seem serious and set for self-sufficiency judging by their determination to attain sustainable returns on investment for their shareholders, high loan recovery rates, their cost recovery pricing, their growing borrower and loan portfolios, and their seriousness with ensuring that bad risk clients are prevented from entering credit relationships. There are however serious challenges that the institutions face, which in a way reduces their capacity to attain desirable levels of outreach, impact and returns on investment. Some of the challenges are highlighted in this paper.

4.5 Key features and trends of the lending technology and the relationship between clients and lenders in Beira

4.5.1 Lending technology

- A long-term relationship is more valuable for both lenders and clients than a one-off arm's length transaction
- Loans are tailored to individual demand, but more importantly to the capacity and willingness to repay
- Loan officers are the people through which the clients relate to the institutions
- Loan granting decisions are taken and communicated quickly
- Clients are monitored frequently through both programmed and surprise visits

⁶⁴ Interview with Carlos, senior officer of institution B

- Services are personalised
- Greater emphasis on social mobilisation transparency and communication
- Non-traditional mechanisms for managing risk and delinquency are used: non-traditional assets, frequent repayment schedules, short terms to maturity, small initial loan sizes, subsequent improvement in terms and conditions

4.5.2 Characteristics most appreciated

- On the whole entry requirements such as documentations are considered realistic especially for subsequent applications
- Guaranteed availability of credit to those who qualify
- Promptness in credit granting or rejection decisions
- Personalised services
- Adaptability of terms and conditions to individual clients on the basis of their needs and capacity to repay
- Subsequent improvements of terms and conditions e.g. repayment plans and terms to maturity
- High quality service- clients say they are treated with respect like equal parties in a win-win deal
- Wider variety of products offered
- Transparency- clients are happy that they enter credit relationships knowing what the responsibilities of the two parties are exactly.
- The possibility for contract renegotiations
- The location of the branches is convenient for them
- Assistance given to clients by loan officers on how to improve their business and produce records

4.5.3 Characteristics least appreciated

- Rigid initial entry requirements
- The co-signer, collateral and the twelve (12) months business experience, high interest rates
- Too many personal questions including enquiring about them from others who could lie about them due to personal differences⁶⁵
- Lack of systemic business support development programmes
- Limits on the sizes of the loan

4.5.4 Challenges the clients face

- Saturated markets with many people doing the same kind of business hence low levels of returns on investments
- Having to resort to informal lenders in order to keep up with their repayment plans so that they are not excluded from formal credit markets due to a history of default
- Poor public services such as water and electricity, which are often expensive when available
- Lack of systematic technical assistance on managing enterprises
- Poor conditions in the markets where they do their business which keep clients away especially during rainy seasons because the area is swampy with rudimentary infrastructure.
- Clients are obliged to ferry their inventory from home and to the markets at the beginning and end of each day due to lack of storage facilities in all major

⁶⁵ This concern was expressed by 15 out of the 20 active clients interviewed. Some of the personal questions mentioned include the number of wives and in the case of those who are divorced, the reasons for the divorce

markets⁶⁶

4.5.5 Challenges to the institutions

- Low levels of returns due to high administrative costs and macroeconomic fluctuations (exchange rates and inflation)
- Most clients can not meet the actual requirements yet they are considerably fair
- Difficult to recruit competent loan officers locally, it is even more difficult to retain them- this is a serious problem considering that loan officers are often subjected to expensive training and their short stay with the institutions constitute great losses to the institutions
- Lack of capacity to provide more systemic business support programmes
- High levels of risk aversion which leads to slow expansion in borrower portfolio

4.5.6 What lenders appreciate from their clients

- Lenders appreciate that clients understand and accept the rationale for most of the requirements, terms and conditions although they find some of them rigid and difficult
- Lenders are generally happy with the repayment behaviour of their clients and their commitment to reveal information that the lenders need to make credit decisions
- Lenders are happy with high levels of referrals from active clients
- Lenders are happy that active clients purchase credit on a recurring basis
- Lenders are happy that clients are increasingly using other products such as savings

⁶⁶ The lack of storage facilities is visible and was observed by the researcher. The markets are mainly rudimentary structures characteristic of informal constructions. In the early hours of the morning and of the evening the movement of people carrying their belongings to and from the market are common,

- Lenders are happy with the fact that clients generally communicate problems early enough at stages they can be remedied
- Client loyalty, clients generally purchase services and products from the same institution and fulfil their obligations such as repayment.

In general, the majority of the poor do not manage to meet the requirements. High levels of poverty and constraining macroeconomic environment make it difficult for most of the poor to manage the minimum social and economic capital necessary to manage debt. Profit opportunities are scarce in a macroeconomic environment in which per capita incomes are low and infrastructure is almost non-existent and weak. Therefore, with reduced entrepreneurial opportunities and a weak asset base most among the poor do not qualify for commercial micro-credit, which further impedes the development of entrepreneurship among the poor.

Furthermore, according to Athmer and Hunguana (2004) the low levels of outreach, in the country as a whole, are due to the fact that institutions target very high⁶⁷ by concentrating on low risk clients. This was indeed confirmed by a respondent from one of the institutions, who affirmed that,

...although we do not intend to attain sustainability and ensure sustainable returns on investment for our shareholders on a short-term and at the expense of our clients, we have to ensure that we are lending to clients who have a demonstrated capacity to run productive enterprises and repay loans. This is important for our survival as an institution, we can not afford to repeat the mistakes made by development banks like BPD [People's Development Bank] which collapsed because they did not ensure that they lent to clients who were able and willing to repay. They failed even with subsidies; what about us who depend on loans from other lenders and revenues from our products? This is not to say that we do not want to see our borrower portfolios expanding but that we have to be careful. It is my hope that

⁶⁷ To target high means that their entry requirements are too high to be met by the majority of the poor hence the incidence of the moderate poor and above in the credit programmes

in the long-term many people will have access. We are doing all we can to achieve this...⁶⁸

It is evident, from the above response, that with this kind of targeting, which is not necessarily bad from a financial sustainability point of view, indeed many needy clients at least in the short-term will continue to face exclusion from formal credit markets in Beira. If microfinance has to have any meaningful impact lenders should take a bit more risk than they do at present, by coming up with substitutes for some entry requirements and risk management mechanisms e.g. collateral that often prevent many needy people from entering credit relationships.

An important lesson learned from this study is that the microfinance industry alone can only achieve symbolic impact on entrepreneurship and poverty reduction, a realisation often overlooked by promoters of microfinance hence the over enthusiasm with microfinance and less attention on the identification of other more practical poverty reduction tools or those than have a complementary relationship with microfinance e.g. safety nets.

⁶⁸ Interview with Mr. Boris the Senior officer of Institution A

5. THE NATURE OF THE RELATIONSHIP ESTABLISHED BETWEEN THE TWO CASE STUDY INSTITUTIONS AND THE CLIENTS

This chapter examines the nature of the relationship between the two institutions and their clients. The research draws on the relationship measures and dimensions⁶⁹ highlighted in the literature review chapter, to examine the nature of the relationships established between the institutions and their respective clients. The chapter concludes that the relationship between the institutions and the target group is a close relationship of a long-term nature charged by levels of repeat borrowing, progressive lending and other aspects discusses in the chapter. The information on which this chapter is based was obtained mainly through interviews with clients (both active and potential) and with officers from both institutions. The information is further discussed in relations to the literature reviewed in the ambit of this search project.

5.1 The nature of the relationships between the institutions and the clients

5.1.1 Close/‘personal’ relationships

The institutions and their clients are engaged in close relationships. The institutions literally go to potential clients and engage them individually in order to elicit the information necessary for establishing their credit worthiness, understand their needs -so that products are developed to match those needs, and attract potential clients and maintain

⁶⁹ Relationships measures refer to all the aspects that are fundamental for building relationships and/or those aspects that characterise the existence of a relationship.

them in the relationships.

As one respondent put it,

We believe in staying close to our clients and in knowing them personally because they have different needs and we need to ensure that we meet most of those needs, and as such we invest in cultivating strong and lasting relationships with our clients, some times our loan officers end up establishing social ties that have little do to with business but are inevitable given the level of interaction and trust that develop among them, these include mediating family conflicts and much more⁷⁰.

This practice is common in Bangladesh particularly in the case of the Grameen bank, where loan officers end up being counsellors to some of their clients on personal issues at the request of the clients. In this regard, Woolcock observes that,

the Grameen bank loan officers are often called upon to assume the roles of marriage counsellors, conflict negotiators, training officers and civic leaders. At the same time the loan officers gradually acquire information about borrowers' credit worthiness which can be used in enforcing repayment schedules and other programme decisions (in Navajas, 1999, p.16).

It is, therefore, worth noting that matured credit relationships go beyond simple financial transactions to include social and personal relationships.

5.1.2 Multidimensional relationships

The relationships between the two institutions and their clients are multidimensional. This means that the relationships are not confined to credit alone but are extended over multiple products including savings, technical support -although not systemic, money transfers etc. In the reviewed literature, this multidimensionality is known as scope.

Scope is one of the most celebrated relationship measures (Berger et al, 2001 and

⁷⁰ Interview with Carlos, senior officer for institution B

Nalukenge, 2003). In terms of scope, referred to in literature as the number of products a particular client purchases from the same lender and the intensity thereof (Cole, 1998; Ongena and Smith, 2001) it can be said that the relationships between the institutions and their clients are strong and multidimensional.

5.1.3 Individual clients borrow from one formal institution

Most of the clients interviewed said that they purchased all their financial products from their particular institutions except for those the institutions do not supply. Respondents believe that if they purchase all their products and services from the same institutions the transactions are faster and they develop a reputation of patronage from which they hope to benefit in the long-run. This is evidence for the strength of the relationship between the clients and the lenders. Thirty percent (30%) of the respondents said, however, that they still resort to relatives and friends when they need additional money to keep up with their repayment obligations with the institutions for fear of being excluded from the credit programmes⁷¹. Although fear is not a good attribute in a relationship, the preoccupation with staying in the programme is a positive indication that clients indeed value their relationships with lenders.

5.1.4 Long-term relationships

The institutions and the clients, particularly active clients are engaged in long-term relationships. The institutions are profit oriented and set to stay at the service of their clients in the long-term. Clients on the other hand would like to have continuous access to credit and go to great lengths to repay their loans.

⁷¹ This shows that strong social networks are beneficial for both the poor clients and the lending institutions.

This is indicative of the strength of the relationship between the lenders and the clients; since the strength of the relationship between lenders and borrowers is mainly measured in terms of duration (the time period a given client has stayed with the a particular institution (Elyasiani and Goldberg, 2004; Berger and Udell, 2005; Petersen and Rajan, 1994), one can conclude that there is strong long-term relationship between the two (2) institutions and their clients.

The institutions, just like the clients are particularly interested in long-term relationships and deliberately invest time and effort to build and sustain such relationships. In this regard, a respondent said that,

we invest in retaining our clients by providing them with the best possible quality of services because the cost of acquiring new clients is far greater than the cost of maintaining a relationship with a current client for long periods of time⁷².

In the same vein, a client said

I will always borrow from [the institution] because I have children to feed and send to school. My business is the one that gives me the money to manage that, without credit I can hardly survive this is why I would like to stay with the institution for as long as possible, staying with my institution is important for me because I do not have go through the complex process that people undergo when there are taking loans for the first time⁷³.

Another respondent state that,

With my business I can only make enough money to feed my family and survive. I do not make a lot of profit to be able to save or buy property, because of this I always find it necessary to borrow from somewhere, be it the bank, family or local money lenders, since I am happy with my bank I will stay with it may be for ever God willing⁷⁴.

⁷² Interview with Boris, senior officer for institution A

⁷³ Interview with Joaninha, client from institution B

⁷⁴ Interview wit Castigo, client from institution B

The need for credit on a recurring basis is one of the reasons why clients would want to develop and protect long-term relationships with the institutions. In response to the question why they found it important to repay their loans common responses included: “*so that when I apply again they will give me*⁷⁵” and “*so that the institution does not go bankrupt and leave us with not source of credit*⁷⁶”. Whatever these responses may mean, one thing is clear, clients seem to care about the survival of the institutions and continuing with the relationship. One respondent explained why she made sure she paid her loans punctually in the following terms,

I pay because if I do not pay the bank will ‘die’, I know it sounds ridiculous to make it appear as if one person alone can kill the bank, but imagine if many of us do not repay, it will certainly die and there is no many without one so my paying is important for the bank. You know before banks like [this one], we struggled to get credit; I do not think anyone wants to experience those moments again by killing these banks. I always tell my friends this I am telling you now⁷⁷.

An important aspect that stands out in this interview extract is that clients are conscious about repayment and they mobilise each other to repay their loans and abide by other contractual obligations.

The institutions report high levels of client retention and repeat borrowing, these aspects are proxied with strong long-term client-lender relationships (Boot, 2000; Berger and Udell, 2005). The institutions report that between sixty-five (65%) and seventy percent (70%) of their clients have been with them for four (4) years and have taken more than four (4) loans⁷⁸.

The majority of the clients usually apply for further loans after their first one. Seventy-five percent (75%) of the respondents said that they had been with the institutions since the

⁷⁵ Interview with Caetano, client from institution B

⁷⁶ Interview with Maita, client from institution A

⁷⁷ Interview with Abilio, client from institution A

⁷⁸ Institution A reported that 75% of their clients are repeat borrowers and institution B reported 65%

year 2002 and had taken more than four (4) loans, further confirming the information given by the management of the two (2) institutions. It is therefore evident that the institutions and the clients value long-term relationships and invest time and effort to build and sustain such relationships.

5.1.5 Win-win relationships

The relationships between the clients and the institutions can also be described as win-win relationships. In general the relationships are characterised by fairness on the part of the institutions and loyalty in terms of repayment on the part of the clients. The clients get the credit and other services and other forms of support from the institutions, and in return the institutions get returns on their investments through the fees and other charges, paid by the clients. The institutions are generally happy with the repayment behaviour of their clients and the clients do not feel exploited by the institutions, in fact they are happy to be associated with reliable formal lenders.

Clients often contribute to the building and sustaining their relationships with lenders by keeping their relationship obligations, particularly repayment (Ongena and Smith, 1998; Bharath et al., 2004). Going by the levels of repayment and the prospect of self-sufficiency of the institutions, one can say that the relationship between the clients and the institutions is a win-win relationship.

In accordance with the *relationship lending* literature, the lending technology employed by the two institutions, the perceptions and the attitude of both the institutions and the clients towards one another point to the existence of good rapport between or among the parties; especially in as far as active clients are concerned. The positive repayment performance of the clients of both institutions (97% repayment levels are reported by the institutions) are

suggestive of, among others, the satisfaction of the clients with the service they get particularly after their first loans. This is further corroborated by the levels of repeat borrowing for both institutions which stand at over 65%. Therefore, clients get access to credit on the one hand, and the institutions gain the loyalty of their clients and enjoy good levels of repeat borrowing and high repayment rates.

5.1.6 Relationship of tolerance

Consistent with the *relationship lending* literature (Dahiya, et al., 2003) and as an indicator of the strength of their relationship with clients, the institutions are open to renegotiating contract terms such as postponing repayments or even refinancing established clients who face emergencies or crisis which can be overcome by making more money available to them. A respondent from one of the institutions said that,

we understand that every individual can face challenging situations which they can not control. In such cases we do reschedule repayments or refinance clients provided it is evident that the problems are genuine and that the clients are able to bounce back. We, however, try to limit this practice because of the danger that clients might misuse this provision⁷⁹.

Indeed four (4) of the twenty (20) clients interviewed confirmed that they were given a loan even though they had arrears that resulted from misfortunes that were beyond their control. These clients are established clients, two (2) have been with the respective institution for five (5) years and the other two (2) for four (4) years.

The answer, therefore, to the question of what kind of relationship is established between the two formal microfinance institutions and the poor in Beira-Mozambique, is that it is a close long-term relationship in which the clients are generally satisfied with the services

⁷⁹ Interview with Carlos, senior officer for institution B

they get, and the institutions are happy with the general repayment behaviour of their clients.

5.2 How relationships are built and sustained

The means through which the relationships between the clients and the two institutions are built are in accordance with relationship building process outlined in the literature review section particularly the subsection relationship building processes and dimensions. These include:

5.2.1 Locating office branches near the target group

The institutions are located within walking distances from both the homes and the business premises of the target group (near informal and formal market and populous suburbs). Respondents confirmed that their decisions for choosing the particular institutions were partly informed by geographic proximity since they do not have to walk long distances to the branch office or incur transport costs. One respondent had this to say in relation to the location of the institutions,

I do not need any transport to go to the bank. I can walk to it from here [market]. It is also not far from my home. It is so convenient I like it, this is one reason why I choose it⁸⁰.

Proximity is therefore indeed decisive for relationship building and sustenance, especially in this particular market. As one respondent put it,

it is common sense that if you are close to them [clients] both physically and emotionally it is ease for us to interact with them and provide support. It makes our relationship stronger. The fact that they see the institutions almost every day also serves to remind them of their

⁸⁰ Cufa, client from institution B

obligations with the institution, and it makes it easy for them to visit the office⁸¹.

This is consistent with Bharath, et al., (2004), Schmidt and Zeitingner (1994) and Beck and da la Torre (2004) who consider the location of branches near the client base as important, not only for attracting clients into credit relationships with lenders but also, for maintaining them in the relationships.

5.2.2 Personal selling and social mobilisation

The institutions do very little indirect marketing, but rely instead on word of mouth, often one-to-one marketing⁸². The marketing strategy employed by the institutions constitutes the only way the institutions relate to the target group or market niche as a whole.

The level of social mobilisation, particularly the personalised way in which marketing is done, puts the institutions closer to most people who are have the potential to enter credit relationships. Respondents confirmed that loan officers are often out in the field mobilising people to enter credit relationships with their institutions. One respondent said in this regard that,

I have had several contacts with loan officer from both institutions. They are very nice people, they have time and the patience to explain how the credit programme works and they even give us advice on how to improve our business. I am not in the credit programme myself but each time they are in this market they relate to us in a good way⁸³.

Therefore, the institutions are not only close in relation to their current clients but to the target group in general⁸⁴.

⁸¹ Interview with Carlos, senior officer for institution B

⁸² Information from senior officers and loan officers of both institutions

⁸³ Interview with Amelia, potential client

⁸⁴ Five non-clients who were interviewed several months (05-12 October 2006) after the twenty clients have said that they have had several contacts with loan officers from the two institutions but have fallen short of

Consistent with Wright et al., (2003) personal selling or marketing constitutes an important first step in the establishment of client lender relationships. More importantly, it is the means through which effective credit relationships are built and maintained. The majority of the respondents interviewed (15 of the 20) confirmed that, before being approached by the loan officers they did not think they could be eligible for credit with any of the two institutions. This is consistent with the ADB (2000) which considers social mobilisation to be instrumental for helping the target group take advantage of opportunities to engage in credit relationships with formal lenders. According to Wright, et al., (2003) personal selling:

provides a unique opportunity to educate clients...since it involves having field staff ... out in the cities, towns and villages selling the MFI and its services...making presentations to each and any gathering of the target market – from school open days to meetings of vendors' associations...employers needing efficient banking services for their lower-paid staff (p.15).

Personal selling and social mobilisation are important for giving individuals confidence to engage in credit relationships.

This is also consistent with Hashemi et al., (2006) who argue that risk aversion among the poor is more a confidence problem than a true reflection of fear of taking risks. This is further consistent with Chakravarty and Yilmazer (2005) who consider relationships as not only important in the loan granting decision but also on the decision to apply. This is corroborated by fourteen (14) of the twenty (20) respondents who said that the fact that their loan officers related to them even before they joined the institutions impressed them and made them realise that their chances of getting credit were high.

joining the institutions for reasons ranging from failure to meet the entry requirements to simply choosing not to be in debt. The generally seemed to be happy with interest free loans from family and friends.

Another salient variant of relationship measure marketing, which is consistent with Ongena and Smith (1998), is the participation of active clients in the marketing of their respective institutions. Loan officers interviewed in the ambit of this research project indicated that established clients play a critical role in marketing the institutions to friends and relatives. A respondent affirmed in this regard that:

Our clients are important actors in the marketing of our institutions and products. Most of our clients get to know and enter our credit programmes through their acquaintances⁸⁵.

In fact, about forty percent (60%) of the clients interviewed said they came to know the institutions through their friends and/or relatives. The remaining 40% said that they knew the institutions through loan officers and/or through the promotional campaigns carried out by the institutions.

5.2.3 Communication and Transparency

As can be inferred from the description and analysis of the lending technology employed by the institutions in the previous chapter, lenders deal with their clients in a transparent⁸⁶ way. Emphasis on communication is an important incentive for clients to enter and stay in credit relationships (Gonzalez-Vega et al., 1996).

Asked about the requirements for entering credit relationships with their respective institutions, respondents seemed well informed about all it takes to engage in a credit relationship with the two institutions, including the bureaucratic exigencies, the borrowing process, loan terms and conditions, and what they should expect from the institutions and

⁸⁵ Interview with Rosa, loan officer for institution B

⁸⁶ Transparent or transparent means that the rules of the game are clear to all participant and they are actually observed especially by the lender

what the institutions expects from them. They know the exact amounts they have to pay for the loans they take, when and how to repay. One respondent said,

I know the whole process; I knew it before I started borrowing because the loan officer explained it in a way poor people like me who did not go to school can understand. I went through it [the application process] many times but the loan officers never takes it for granted, they keep explaining things as if it was your first time; it is good. I do not understand the percentages and the likes but I know the amounts I have to pay, part by part, principal, interest, commission...⁸⁷.

Respondents in general seemed impressed by the fact that loan officers give them as much information as they want, most times in a simple and easy to understand form. Loan officers are also happy with the levels of information disclosure by the majority of their clients. One of them commented in the following words,

There is generally good communication between us and our clients, which make it easy for us to adapt out products and lending technology to match their needs. Generally, when clients are having problems we hear it directly from the concerned clients themselves; we usually encourage this practice⁸⁸.

Transparency and communication are therefore important factors for building and sustaining relationships for it fosters mutual trust between the parties. In fact, Brusky and Fortuna (2002) argue that transparency is essential for the establishment of strong relationship between the institutions and their clients.

⁸⁷ Interview with Muti, a client from institution A

⁸⁸ Interview with Garicai, loan officer from institution A

5.2.4 Progressive lending

The two institutions often start by giving their clients smaller loans than they actually qualify for, with the promise of larger loans with the intuition of testing their willingness and ability to repay debt. When clients perform well, loans are gradually, increased. This process leads to greater client retention and the consequent establishment of long-term credit relationship between the institutions and the clients. A respondent confirmed this by saying that:

One way we ensure use to keep our clients in a long-term relationship with us is by giving them loan sizes that are just enough for their current projects and promise larger subsequent loans provided they show improvement in their debt management practices⁸⁹.

In the same vein another respondent said,

...by giving our clients small initial loans and increase them with subsequent applications we learn about the capacity of the borrower to manage debt before we commit large amounts to the particular client on the one hand, and on the other we encourage the borrower to borrow repeatedly⁹⁰.

Although the sample both of the lending institutions and the interviewees is small, two (2) and thirty one (31) respectively, the analysis suggests that, in Beira progressive lending is, in addition to being a risk management mechanism as is traditionally known, also an instrument used by lenders to build and maintain close long-term credit relationships with clients.

⁸⁹ Interview with Carlos, senior officer for institution B

⁹⁰ Interview with Boris senior officer for institution A

5.2.5 Frequent repayment schedules

Consistent with *relationship lending* literature particularly de Aghion and Morduch (2000) who argue that “*regular repayment schedules help offer bank staff with the protocol by which to get to know clients over time, in this way personalised relationships are established just as with local money lenders*” (p.13), the two institutions also employ another risk management strategy, namely frequent repayment schedules as a relationship building and sustenance instrument. Clients have to repay their loans on a monthly basis. They have to visit the branch office of the respective institution to make the payment; during this period the institutions have an opportunity to have contact with the client. Over time the client and the institution get used to and to know each other well, hence the solidification of the relationship. As a respondent put it:

By asking our clients to make frequent repayments we have repeated opportunities to track our clients, learn more about them and retain them in our credit programmes⁹¹.

Frequent repayment schedules are therefore a means through which repetitive contact between the institutions and the clients are made. This ensures that they develop a relationship of closeness resulting from continued interaction.

5.2.6 Quality of service

The management of the two institutions affirmed that one of the central pillars of their lending technology is the quality of service they offer to their clients. One respondent said,

In all our practices we ensure that our clients have the best possible treatment and quality of services. We value professionalism and promptness, in providing clients not only with what they want but how they want, provided it is within their capacity and willingness to

⁹¹ Interview with Boris, senior officer for institution A

repay in the case of credit⁹².

The respondent went on to say,

to achieve this we stay as close as possible to our clients and develop a personal relationship with each of them because we are aware that they have different needs, which can only be met if we are personally related to them and understand them better⁹³.

One of the most important issues outlined by the clients in this regard was the fact that they were treated with dignity and that loan officers were always ready to help them with matters pertaining, not only, to their debt but also their businesses. A respondent confirmed this when saying,

of all the places I have gone for services in this city, the only place I have seen poor people like me being treated like a real client and person, is at my bank. People there are very friendly and professional. I have had to pay bribes in many places because this is the most common way you make some people remember you are a person like them. But with this bank and [that other one] I have never had people complain about bribes. If people everywhere worked like them, this country would go far...I am not saying we never get no as a response at the bank, we get that many times but it is not done in a way as if to say never come back here, I hope you understand what I am saying...⁹⁴.

A closer look at the lending technology employed by the two institutions, described in the previous chapter, shows that the services, from marketing to disbursement and throughout the lifecycle of the loan, are quick and highly personalised; with loan officers being meticulous in the whole application process. Furthermore, clients do not necessarily need to go to the institutions all the time for information or any other thing that can be offered at their homes or business premises because the institutions literally go to them. As one loan officer put it,

⁹² Interview with Boris, senior officer for institution A

⁹³ *ibid*

⁹⁴ Interview with Chicamisse, client from institution A

we spend very little time in our branch offices, we are field workers out to win more and more clients and keep in touch with current clients⁹⁵.

Indeed, service delivery is highly personalised with loan officers literally establishing personal contact with individual before, during and after the actual credit relationships are built. In delivering credit and other products, the specific needs of individual clients are taken into account and efforts are made to ensure that the products are delivered the way the clients want, especially after the first transaction. This does not necessarily mean that clients get exactly what they want, but they get what they can manage. Loans are often contingent on the clients' income flows and the capacity to manage debt.

The impact of quality personalised services on relationship building and sustenance is emphasised by Gonzalez Vega et al., (1996) in their work on Banco Sol in the following terms: *“The highly personalised service offered to the clients represents an additional powerful incentive for repayment. A long-term connection is developed between the loan officer and the borrower and powerful information incentives to fulfil contract commitments emerge from this bond (p.16).*

5.2.7 Encouraging clients to be savers

Another means through which the two institutions build and sustain close long-term relationships with their clients is by encouraging them to open saving accounts. This is also the practice at the Grameen Bank, except for the fact that in the case of these two institutions saving is voluntary not compulsory. As a senior officer from one of the institutions stated that:

⁹⁵ Interview with Luisa, loan officer for institution B

To build and sustain our relationships with the clients we encourage them to be open savings accounts with us, because we understand that relationships are stronger when you are related in more ways than one⁹⁶.

This is an important mechanism for building long-term relationships since clients may develop more affinity with the institution by knowing they have some stake in the institution.

5.2.8 Conclusion

This chapter concludes that the two formal microfinance institutions and the target group, particularly active borrowers with good repayment performances, are engaged in close long-term relationships. The relationships are mainly characterised by personalised service delivery from marketing to loan recovery, and considerable levels of repeat borrowing as was shown earlier in the paper. The institutions as well as the clients continuously strive to build and maintain the relationships in various ways, among them progressive lending, better terms and conditions for subsequent loans, emphasis on communication in the case of the institutions and repeat borrowing and good repayment performance in the case of the clients.

⁹⁶ Interview with Boris senior officer for institutions A

6. BENEFITS ACCRUING FROM THE RELATIONSHIP BETWEEN THE INSTITUTIONS AND THE TARGET GROUP

This chapter examines the benefits that both the institutions and the target group gain from the established relationship between them. In the previous chapter the study concludes that the relationships between the two parties are close and have a long-term horizon.

In general, theoretical and empirical research on financial intermediation, finance and banking, reveal that the stronger the relationships becomes, the more and the easier the information necessary for making lending or borrowing decisions is shared between the parties (Bharath, 2004; Degryse and Ongena, 2000). Berger and Udell, 2002 contend that the stronger the relationship, the less costly it becomes to gather information about the borrower and that product development becomes more responsive to the needs of the clients⁹⁷.

It is further argued that the stronger the relationships between clients and lenders, the higher the client discipline and repayment behaviour (Berger at al., 2001; Churchill, 1999, 2000); the greater the sustainability of the institutions (Petersen and Rajan, 1995; Mishkin, 2004); and the more accessible and available credit becomes to the target group (Ferri, 2001; Mishkin, 2004; Hashemi at al., 2006). All of these benefits enhance the probability of greater entrepreneurial development among the target group and greater financial sustainability for the lenders (Schmidt and Zeitinger, 1994).

This study finds the relationship established between the two institutions and the clients in Beira, to have more or less the same benefits to both clients and lenders as those outlined

⁹⁷ See also Boot, 2000 and Chakravarty and Yilmazer, 2004

in the literature. The benefits seem to be more relevant for active clients, although the target group in general benefits from contact with formal lenders through the marketing strategy they employ, which blesses them with some sort of borrowing education or awareness and more importantly the prospect of joining the institutions in the future.

6.1 Benefits to the lenders

6.1.1 Greater information acquisition for effective screening and product development

Information sharing in the case of Beira is one of the benefits of the relationship established between lenders and the clients, both potential and active. The strength of the relationship between clients and lenders, and their daily interactions, give lenders an idea of the risk profile of clients which facilitates the screening of ‘bad risk’ clients from the good risk ones and gives them a clear idea of what clients want and need. The institutions are able to identify more or less what clients like and dislike and why, and to make timely and suitable responses⁹⁸.

A respondent from one of the institutions said in this regard that,

the relationship we develop with our clients both potential and active helps us get most of the information without which lending would not occur or would occur with great difficulty because most people do not have records of their businesses transactions nor have the capacity to produce them. We base our lending on estimates of their incomes and reputations obtained from our interactions with them. Note also that we manage to match our practices and products to their needs because our relationship helps us understand them⁹⁹.

⁹⁸ Information from Boris, senior officer for institution A

⁹⁹ Interview with Carlos, senior officer institution B

Close long-term relationships are there for instrumental for information gathering and product development that meets the needs of the clients. Meeting clients' needs is not only important for lenders to establish a reputation for service but also to help clients manage their loans effectively, hence ensuring repayment and their own development as reputable clients, and in so doing enhancing their financial and business opportunities in local markets as well as the sustainability of the lenders..

6.1.2 Reduction in costs of provision

Lenders claim that their relationship with clients helps them minimise lending related costs. They say that they need less time and effort to establish the creditworthiness of an applicant with whom they are closely related, giving the loan officer time to deal with others and as such enhance their own productivity. Furthermore, their relationship helps them evaluate the applicants more accurately and as such minimise the probability of losses from default. As a respondent put it,

knowing our clients personally helps us understand the environment in which they work and their capacity to manage debt which helps us reduce the chances that a bad risk client is approved or vice versa, this is generally much easier with repeat borrowers¹⁰⁰.

It is therefore clear that lenders do indeed benefits from establishing close long-term relationships with clients by having their lending costs reduced. This is important for the sustainability of the institutions given that micro lending is a very costly business which can not be sustained by fees and interest rates alone but by a combination of factors including the reduction of lending or administrative costs.

¹⁰⁰ Interview with Boris, senior officer institution A

6.1.3 Easier monitoring of clients

Institutions find it ease to monitor clients because the relationship helps them understand clients well and have access to their households and business premises when necessary,

because we know our clients well and we are often welcome to pay them visits often stopovers when we are in the field it is very ease for us to spot any signs of trouble that may lead to default early enough to deal with it accordingly, not necessarily harshly¹⁰¹.

Therefore developing close long-term relationships with clients makes it ease for lenders to monitor clients to check for any changes in their risk profiles and/or in fact reduce the need for such monitoring since the strength of the relationship can make clients more responsible and committed to their contractual obligations with little or no monitoring at all.

6.1.4 Better client retention

Client retention is another benefit highlighted by lenders. Lenders have said that the strength of their relationship with clients helps them retain clients. In this regard, a respondent stated,

An important benefit that emanates from our relationship with clients is that most of them stick with the programme. This brings us further benefits because the clients cost us less in terms of monitoring and usually get larger loans which significantly reduce our costs because smaller loans are very expensive; since loan officers tend to spend less time on the application and assessment processes of repeat borrowers, retaining more clients improves our operational efficiency¹⁰².

This is consistent with Ongena and Smith (2001) and Wright (1997) who argue that retaining clients is important for sustainability and efficiency. Indeed most of the clients interviewed affirmed that they would stay with their respective institutions because they

¹⁰¹ Interview with Miguel, loan officer for institution A

¹⁰² Interview with Boris, senior officer for institution A

are generally happy with their services.

6.1.5 Enhanced client discipline and high repayment rates

One of the benefits of the relationship established between the institutions and the lenders most cited by respondents within the institutions and consistent with Churchill (2000) is enhanced client discipline, particularly when it comes to repayment. Lenders believe that their ninety seven percent (97%) repayment rate is a direct result of the rapport between them and the clients.

As one respondent put it,

above all the mechanisms we put in place to encourage repayment, treating our clients as if they were shareholders of the institutions helps us attain high levels of repayment. Our clients are loyal because we communicate to them the values of being loyal not only verbally but also by keeping our promises and assisting them whenever we can¹⁰³.

In response to the question why they paid their loans, most respondent gave reasons including: to ensure that the institution did not go bankrupt and leave them and others without a formal source of credit, fear of exclusion from future access to loans from any formal institution, the need to preserve the relationship with a reliable lender and fear of losing the goods they pledged as collateral. In great part these responses actually show that indeed the institutions have given their clients some degree of education which makes them understand the need to repay their loans. It is, therefore, evident and consistent with Schmidt and Zeitinger (1994) that when the lender is closely related to the client and the deal between them is well understood, strong client lender relationships are fundamental in ensuring repayment.

¹⁰³ Interview with Boris, senior officer for institution A

6.1.6 Borrower and loan portfolio expansion

Borrower and loan portfolio expansion results from the relationship between the clients and lenders. Sources from within the institutions said that because of the strength of their relationships with clients they not only retain clients- who are instrumental for expanding their loan portfolio because they typically qualify for larger loans- but also serve as incentives to draw other clients into the institutions through referrals, supported by the lived experience of active clients. One respondent had this to say in this regard,

the ties that exist between us and our clients benefit us in that the clients who are mainly happy with us will invite others to the programmes, in most cases clients with a good reputation refer clients with an equally good reputation, in so doing helping us expand our client base and take advantage of economies of scale to cover our costs and make profits¹⁰⁴.

This is a critical benefit since it helps lenders benefit from economies of scale, considering that the more clients are served the more efficient the lending can be said to be and the greater the likelihood of making profits. This is, however, not automatic; it depends on the behaviour and risk profile of the clients in the borrower portfolio, if borrowers are not disciplined and the lender fails to provide enough incentives for repayment enlarging borrower portfolio can be disastrous and lenders incur severe losses. This probably explains why lenders try to be too selective when it comes to admitting clients into credit programmes.

6.1.7 Sustainability

One of the two institutions, as mentioned earlier, can be considered sustainable in terms of it being able to cover all its operational costs and even declare profits, however low they may seem, for six (6) consecutive years. The other has only had such good fortune in one

¹⁰⁴ Interview with Carlos, senior officer for institution B

of the six (6) years, but has expanded aggressively, offering about four (4) times as many products as the other institution offers. One explanation is that most of its revenues are ploughed back into expansion¹⁰⁵. One thing is clear from the findings: the clients are not responsible for the average performance of the institutions because they generally have a good repayment performance¹⁰⁶.

The age of the institutions may be a factor in explaining the low levels of sustainability for one institution and no profits for the other. Six (6) years might not be sufficient a time for micro lenders to be making big profit margins unless clients are paying dearly for this. This was highlighted by respondents from within the institutions. One respondent said,

our mission is indeed to provide financial services for the low-income segments of the population and ensure sustainable returns on investment for our shareholders, not in the short-term but in the long-term. We intend to achieve this without passing all the cost burdens to our clients, lest we set them to fail and since we depend on their success for our business, setting them to fail would be equivalent to setting ourselves to fail. In fact I am happy to tell you that we are on the right track and will soon be reaping the fruits of our investments¹⁰⁷.

This explanation is consistent with Wright (1997) who argues that institutions normally “...break even on a customer only after the fourth or fifth loan” (p.2). Considering that the institutions have been in operation for just over six (6) years and going by Wright’s assertion, the institutions seem to be on the right track.

Other official explanations include the macroeconomic instability particularly the fluctuations of the Mozambican Metical (MZM) in relation to the dollar in the past years. The relationship between the institutions and the clients is nonetheless showing encouraging signs that ceteris paribus the repayment behaviour and other advantages,

¹⁰⁵ Information from a respondents from within the institutions

¹⁰⁶ Both institutions exhibit repayment rates of up to 97%

¹⁰⁷ Interview with Boris, senior officer for institution A

including reduced provision and monitoring costs, may eventually lead to greater financial sustainability and returns on investment for the lenders.

In sum, the two lenders in the city of Beira do benefit from their relationship with clients in the same way the relationship literature documents. Through the relationship, the lenders are able to more easily elicit the information they need for selecting, monitoring and matching products and services to the needs of the clientele. In so doing the institutions develop a reputation for service and foster client loyalty to the institutions and, more importantly, their commitment to repay. All of these benefits are indispensable for institutions that depend on revenues from their clients in order to attain self-sufficiency and have sustainable returns on their investments.

6.2 Benefit to clients

Relationship lending literature shows that clients stand to benefit from a close long-term relationship with lenders. Among the benefits accruing to clients are:

6.2.1 Opportunity to engage in credit relationships with formal lenders

The pre-transaction interaction between the lenders and the target group takes place mainly through marketing. The marketing strategy used by the two lenders that hinges on personal selling is beneficial to the clients in the sense that it provides them with the opportunity of having a bit of financial education in terms of borrowing from formal and more reliable lenders. This strategy results in actual credit relationships that clients would have never thought of entering with formal lenders. This fact was confirmed by fifteen (15) of the twenty (20) active clients interviewed. It is worth recognising though that this is a

benefit particularly if the client benefits from the actual credit relationship, which in some instances is not the case.

6.2.3 Simple, quick and flexible application processes

A prior relationship between the lenders and clients often results in simple, quick and flexible subsequent applications. Clients who have taken a loan before or hold an account with the particular institutions benefit from simple application processes and very short waiting time. This is consistent with Dahiya et al., (2003) who have argued that close long-term relationships between lenders and clients make subsequent credit decisions more flexible and quicker than the preceding ones. In this regard one respondent put it,

the first time I took a loan the process was not very difficult but the subsequent times were much simpler. I usually get loans in less than one hour when I finish paying the one I have. The process is very simple, you just have to get through the first one and show the institution you are a serious client by repaying punctually¹⁰⁸.

This advantage was also outlined by a respondent within one of the institutions, who said that,

While in general we ensure that our services are quick and flexible to all our clients, the process is much quicker and more flexible for our repeat clients of whom we have an accumulated stock of information sufficient enough to assess the clients very quickly¹⁰⁹.

Therefore flexibility in the loan granting process is one of the main advantages clients get from winning the trust of their lenders. This is an important advantage considering that the poor who often have immediate needs often prefer quicker and flexible access to credit in order to benefit from emerging opportunities.

¹⁰⁸ Interview with Marcos, client from institution B

¹⁰⁹ Interview with Garicai, loan officer for institution A

6.2.4 Reduced cost of loans

The price of the loan is only indirectly related to the strength of the relationship. Interest rates are fixed at certain loan ranges. Established clients who characteristically get larger loans pay between 0.25% and 0.5% less than first time borrowers who get smaller loan sizes. In short, the price of loans is dependent on the size of the loan. So, if a client takes loans within the same interest rate range, the rates remain unchanged independent of the intimacy and duration of the client's relationship with the institution. This, pretty much, reflects the general theoretical and empirical findings on the effect of relationships on interest rates, with various researchers coming up with different results. Petersen and Rajan (1994) for example, found no relationship between strength and longevity of the relationship between clients and lenders and interest rates in the United States. Boot and Thakor (1994) on the other hand argue that borrowers pay less as the relationship matures.

In the case of Beira, there is an indirect relationship in that often repeat borrowers go for larger loans and as such end up paying between 0.25% and 0.5% less than first time borrowers. However, clients benefit from reduced application costs and transport costs as a result of less bureaucracy and the proximity of branch offices to their homes and business premises.

6.2.5 Collateral

Collateral is also unrelated to the relationship between the client and the lender i.e., regardless of the strength and duration of the relationship between the client and the lender collateral of a value of 120% of the loan is pledged as security for the loans. In all the cases clients have to pledge collateral. As a respondent put it,

We require that our clients pledge collateral for all their loans regardless of the duration of the credit relationship or the number of previous loans taken by the client¹¹⁰.

This is contrary to Boot and Thakor (1994) who contend that borrowers pledge less collateral with the duration and maturation of the relationship, but consistent with Sharp (1990) who contends that collateral is always pledged in any credit transaction involving a non-salaried borrower.

6.2.6 Increased loan sizes

Loan sizes do increase with the duration of the relationship provided the clients' incomes also increase, because the decision on the amount to be given is still dependent on the overall income of the applicant established through the credit analysis that is undertaken every time an applicant applies for a new loan. As a loan officer stated,

we mainly give loans on the basis of the prospective returns on the investment of the client and the general income of the client. Normally, clients improve their income with the first few loans and get larger loans in subsequent applications, not much as a result of the relationship itself but principally as a result of the potential ability to repay¹¹¹.

Therefore the relationship between strong client lender relationships is indirect. The relationship only comes at play when the client demonstrates the potential to manage debt. However the capacity to manage debt can be greatly enhanced by the duration and the strength of the established relationship. In this regard, relationships do influence the size of the loan.

¹¹⁰ Interview with Boris, senior officer for institution A

¹¹¹ Interview with Miguel, loan officer for institution A

6.2.7 Flexible repayment schedules and terms to maturity

Clients with established relationships have the privileged of having more flexible repayment plans. They can choose the length and the frequency with which they wish to repay their loans. Clients often prefer longer terms to maturity and small instalments. Furthermore, repayment plans can be changed ex-post and adjustments are made accordingly. In this regard a respondent affirmed that,

We are very flexible with our repeat clients when it comes to repayment schedules and terms to maturity. We recognise that borrowers often prefer longer terms to maturity and small instalment amounts, we give up to twenty-four (24) months for clients to liquidate their debt, and we also allow them to adjust their terms to maturity if they want, these choices serve as incentives for our established clients to stay with us¹¹².

These benefits are important particularly because they mean that clients' particular needs are taken into account. Furthermore, the repayment plans are developed with the participation of the clients, their commitment to abiding by the plans is enhanced.

6.2.8 Rescheduling and refinancing in times of crisis

Rescheduling and refinancing in times of crisis is perhaps the most important privilege after prompt access to subsequent loans. Clients with a reputation for punctual repayment and well performing enterprises can have their repayment plans adjusted and even be refinanced when they are having a difficult time. One of the clients told of the circumstance that led to her refinancing while having an outstanding loan in the following words,

it was back in 2003 when I was involved in an accident and stayed in hospital with a broken neck and both legs for four (4) months and my business collapsed, there was no one to take care of it, the way I did. My husband tried but since he was always coming to

¹¹² *ibid*

hospital to see me and was not familiar with the business he could not keep it going; our helpers mismanaged the whole thing, I remember a loan officer came to visit me at the hospital and telling me not to worry because when I got better they would discuss the issue and that they would consider giving me a loan to restart because I was a good client, they even allowed me to use the money I had in the account with them to pay my medical bills. I did not believe it at first but it actually happened, and I am back again. I tell my friends to make sure they have a good rapport with lenders because they can help you when you most need¹¹³.

It is clear from this testimonial that the reputation and the relationships clients establish with lenders in this particular case study do benefit greatly particularly in times of crisis. Close long-term relationships are therefore of great value to reputable clients particularly in times of distress.

6.2.9 Prestige of being associated with a formal lender

Clients also enjoy the prestige of being associated with a formal lender in an environment in which access to formal institutions is still a privilege. In this regard, one respondent had this to say,

I value my relationship with the bank because I know that as long as I pay my debts they will always help me and others like me who need credit but can not get it from the big banks. I also like the prestige I get from being associated with the bank. I no longer have to knock on peoples doors when I want money, this can be humiliating and you do not know what they think when you are always asking for money from people¹¹⁴.

The fact that clients such as Tichaona consider it prestigious to be associated with his institution enhances the need for them to protect the relationship hence its strength and duration.

¹¹³ Interview with Laise, client from institution A

¹¹⁴ Interview with Tichaona, client from institution A

6.2.10 Technical and other forms of support

Technical and other forms of support are among the benefits reaped by clients from their relationship with formal lenders. Loan officers go to great length in their relationship with clients to help them in issues related with managing their enterprises such as keeping records, improving sales, marketing and client service. This kind of support is, however, not as systemic as clients would like. It is given informally when loan officers pay the clients monitoring visits or simple stopovers, but as one respondent put it,

...it is better than nothing; at least it shows they care¹¹⁵.

This shows that clients value auxiliary services. Unfortunately in the particular case of Beira institutions are still unable to offer systemic auxiliary services to their clients. There is therefore need for lenders worldwide to consider auxiliary services as important as credit and savings in dealing with the target group.

6.3 Access to credit

The study concludes that the moderate poor enjoy convenient and greater access to credit as a result of their relationship with the lenders. The relationship makes it easy for lenders to screen and monitor them and as such make quick and often favourable credit decisions especially if a prior transaction exists between the two. However, despite the efforts made by the institutions to expand outreach, access to credit is still a problem for the majority of the poor.

A look at the lending technology employed by the institutions including the location of the offices, the marketing strategy, the entry requirements, the minimum loan size and the

¹¹⁵ Interview with, Memba client from institution B

entry process itself can make one conclude with little hesitation that access is easy and levels of outreach are high in Beira. A look at outreach indicators and the size of credit constrained population prompts a change of mind altogether.

The combined borrower portfolios for the two institutions in the city of Beira hardly exceeds five thousand clients (5000) with other few institutions only serving less than two thousand in a market with over thirty thousand (30 000)¹¹⁶ people who could benefit from access and many more who are credit constrained. Most people stay out of the programmes due to the conditions required to enter credit relationships with formal institutions striving for self-sufficiency in a volatile economic environment characterised by high levels of poverty, low per capita incomes, limited and saturated markets and poor infrastructure (Dalglish and Bradley, 2006).

Consistent with Athmer and Hunguana (2004), the moderately poor who have reasonable asset base and diversified sources of income are the most served by formal microfinance institutions in the city. This group of clients can afford the minimum requirements for entering credit relationships and stay in them. This is evidenced by the high levels of client retentions reported by the institutions, which means few new clients are recruited into the programmes. For this group, the relationship they have with the institutions results indeed in greater access; but for those who cannot break through the barrier imposed by their poverty, unfavourable macroeconomic conditions and the requirements enter credit programme, stay at the mercy¹¹⁷ of informal lenders or remain totally engulfed in exclusion.

¹¹⁶ These figures are estimates given by respondents from within the institutions. The figure of 30000 potential clients is an average figure, during the interviews two different figures were obtained from the two institutions one was 40000 and the other 25000.

¹¹⁷ Resort to informal lenders

The study has concluded that the reason why people stay out of credit programmes is that they are too poor to meet the entry requirement for the programmes. This is a paradox because micro-credit programmes are said to be instrumental for helping the poor out of poverty (Littlefield et al., 2003). In other words it is poverty that makes it appear as though there is no culture of borrowing from formal lenders in Beira.

Poverty makes it difficult for people to meet the requirements for entering credit relationships. In fact, the high percentage (40%) of potential applicants who desist after the first credit talk attests to the willingness of people to engage in credit relationships with lenders but more importantly, it attests to the fact that the requirements set by the institutions are beyond the means of many who are willing to enter credit relationships with the institutions. As a result most of them borrow from family, friends, and suppliers¹¹⁸ and in the last resort from informal lenders who charge interest for the loans.

A respondent confirmed that they borrow from friends and suppliers because they are used to it, but more importantly because,

borrowing money from a formal institution is difficult, they want me to have things like television, refrigerator or something big. Most of us do not have even electricity, how can we be accepted. I know the other banks want bigger things than these institutions and some of our colleagues who have the things the institutions want borrow from these institutions many of us can not. May be one day we will¹¹⁹.

The client here raises an important issue related to collateral. Although the collateral asked is indeed non-traditional as described in *relationship lending* literature, the level of poverty of many people make it difficult for them to own even the most basic goods. This raises an important issue that theorists and practitioners must consider when theorising about

¹¹⁸ Credit from suppliers is always in kind; that is the people get products and pay for them at a later stage

¹¹⁹ Interview with Marta, a potential client

microfinance i.e. poverty needs to be addressed, by other means, in order to lift the poor to levels that they can engage with formal commercial lenders who should not be expected to issue free loans, or extend loans with no security or any expected returns on the investments they make to extend such credit.

Furthermore, it is utopian to assume that everyone has the capacity to manage debt or run profitable micro-enterprises to qualify for credit either formal or informal. Put in Morduch and Haley (2001)'s words "*Microfinance is not for everyone...entrepreneurial skills and ability are necessary to run a successful micro enterprise and not all potential customers are equally able to take on debt*" (p.2)

For the moderately poor, those who can afford three (3) meals a day, send their children to school, have one or two employed family members and run relatively profitable enterprises, access to credit is indeed very simple, particularly when they have an established relationship with the institutions. Consistent, with Chakravarty and Yilmazer (2005), once the clients are in a relationship with the lender in which they have presumably established themselves as reputable and reliable clients, they are most likely to apply for loans and have their applications approved much quicker and at improved terms and conditions than first time borrowers without an established relationship with the lender.

This is further consistent with Mishkin (2004) who argues that close long-term relationships between clients and lenders "help lenders to understand their credit needs and creditworthiness. It also lowers the cost of collecting information from exiting borrowers, and makes it possible for people to access loans relatively easily and possibly at lower interest rates" (2004, p.225).

6.4 Entrepreneurship

The two lenders surveyed in the ambit of this study believe that they are doing the best they can to ensure that their clients succeed in whatever they do to generate more income for themselves. For them, credit invested in an income-generating enterprise as working capital or for productive assets leads to the growth of an exiting enterprise and/or the establishment of a new one; profits from the enterprise provide income, and a general strengthening of income sources,

When we reach a decision to actually extend credit to a particular client it is because we would have seen in the client the potential for growing their enterprises, which is why we undertake a thorough credit analysis each time a client applies for a loan. In the analysis we attempt to ascertain that the money we give is enough to help the client seize available opportunities to grow their enterprises. Our loan officers also try to help our clients with ways they can improve their enterprises, in most cases thanks to the loans and the inputs from our loan officers and the efforts of the clients themselves, they manage to actually grow their enterprises and double or triple their earnings¹²⁰.

Additionally, institutions supplying the finance to these entrepreneurs are equally dependent on them for business and expansion of outreach as such it is in their interest that the enterprises prosper. To achieve this they,

...ensure that clients have a quick, convenient and continuous access to credit and that the use to which these loans are put are monitored without necessarily preventing them from taking up profitable opportunities when they arise¹²¹.

The respondents further said that one way they contribute to the promotion of entrepreneurship is,

by ensuring that our clients get the right sizes of loans, pay interest rates, pledge

¹²⁰ Interview with Boris, senior officer for institution A

¹²¹ Interview with Carlos, senior officer for institution B

collateral...serve as incentives for them to put the money into productive use, hence helping them be more entrepreneurial¹²².

Furthermore, besides guiding clients through the borrowing process, loan officers respond to requests for business advice, technical assistance and personal encouragement. This underscores the institutions' seriousness with seeing their clients develop their entrepreneurial abilities and grow their enterprises, for it is on them that the businesses of the institutions' depend.

Although in some cases clients fail to grow, in others borrowers do at least manage to maintain their enterprises thanks to the loans they get from the institutions. As one respondent put it,

Since I started taking loans with the institutions I have never run out of inventory and money as I used to do before¹²³.

Asked whether having sold all the stock [running out of inventory] did not automatically mean having money, the respondent replied that,

not necessarily because the money we get from the business is only enough for feeding our families, and pay our debts. It is difficult to do business to get rich here; there are many of us selling things and very few people to buy¹²⁴.

Two lessons can be learned from this respondent: first, most of micro-enterprises run by the target group are survivalist and as such hardly grow beyond subsistence. Second, access to credit keeps them going.

Not everyone, however, is in the same situation as the respondent. Another respondent

¹²² *ibid*

¹²³ Interview with Lorenzo, client from institution A

¹²⁴ *ibid*

proudly boasted of her success as a result of her relationship with one of the institutions.

She said,

I used the money my brother lent me to start a hair salon business, it was a very good business I had money to buy most of the things I needed, one day a loan officer came to my salon to tell me about credit and how it could help me buy more equipment for the salon and employ more people so that my clients did not have to wait long periods in queues. After he explained how it worked I agreed... My business grew much fast and I decided to sell perfumes and jewellery and I am making even more money than I did before. Now I am planning to expand to other neighbourhoods...¹²⁵.

An interesting difference seems to exist between these two respondents. While the first did not specify where he got the money to start the business, he shows that he had been struggling before entering a credit relationship with a formal lender. From the second, it is clear she got the money from her brother, probably interest free, and more importantly that when she entered the credit relationship she was not credit constrained. A lesson can be learnt from this: that less credit constrained borrowers generally do better than the credit constrained ones and probably explains why the moderate poor have much more access to credit than the poor.

In the main, however, it was common even among the clients who seemed to do well in their businesses, to complain about how difficult it is to do business in Beira, citing things like poor infrastructure, lack of systemic business support programmes, low levels of sales due to low incomes and the rising prices of commodities, all of which fall outside the ambit of lending institutions.

All in all, the lending practices of the two institutions, particularly their emphasis on financing existing businesses, and their seriousness with repayment, ensures that clients

¹²⁵ Interview with Joaninha, client from institution B

use the money to generate income¹²⁶ without which their livelihoods would be negatively affected. Furthermore, the technical support which the institutions give to their clients underscores their intentions to help clients improve their income generating capacity. What seems to hinder the growth and development of small businesses is the economic environment in which they operate.

¹²⁶ There instances when clients actually use the money for consumption, the institutions are not concerned with the use to which the money is put but generally with repayments

7. CONCLUSION

This study concludes that the two institution and some of the poor, particularly the active clients, are engaged in a close long-term relationship. The closeness of their institutions to the clients is evident in both physical and relationship terms. The institutions are located near their client base and maintain regular contact with their clients throughout the relationship, from marketing to repayment. Marketing is done directly through personal selling. This means that the institutions, through loan officers, market their products personally to individual clients. In the process, the loan officers take the opportunity to provide the potential clients with some financial education, including how to source external financing for their micro-enterprises. They also give them the confidence and encouragement to enter credit relationship with more reliable formal lenders, such as the loan officers' respective institutions.

The application process is simple and personalised, with the loan officers guiding the applicants through the process with a great deal of friendliness and professionalism. Rejections are done in a friendly way giving the rejected applicants hope to enter credit relationships in the future provided their work on the issues cited as having led to the rejection.

All in all, in Beira, access to credit is still a huge problem for most poor people despite there being a considerable use of relationship lending. The problem is that lending in Beira is still very risky due to high levels of poverty, the absence of cost effective legal structures for dealing with defaults, a macroeconomic environment, which makes it difficult for micro-enterprises to get quick and substantial returns to investments and other constraining factors. The high levels of uncertainty and unpredictability in credit markets still force

lenders to be risk averse and some stick to traditional lending practices rather than the more risky relationship practices outlined in this research report.

Traditional measures used for securing loans include requiring clients to pledge collateral and co-signers. The idea is that these will encourage clients to take their credit responsibilities more serious and consequently develop a culture to repay their loans and as such qualify to stay in the credit relationship for as long as necessary. It is worth noting though that requiring collateral and co-signers impedes many people with a poor asset basis from entering credit relationships. Therefore, more innovative risk management mechanisms that do not impede the poor from entering credit relationships, nor expose the institution to greater losses from default could be further developed.

Relationship lending, properly implemented, is an important strategy for dealing with the poor particularly because the lenders and the borrowers engage in repetitive interaction which can result in the establishment of solid long term relationships between them. To ensure that they engage in repetitive interaction with their clients, the institutions employ a series of mechanisms to keep their clients in the programme. These mechanisms include: frequent repayment schedules, progressive lending, the improvement of loan terms and conditions with subsequent loans for well performing clients. Additionally, clients are encouraged to save with the respective institutions.

Group lending is one mechanism that is employed elsewhere, it has the advantage that clients are not required to pledge any physical but social collateral and as such it increases the chances of many poorer clients benefiting from access to credit. Furthermore, it reduces lending costs such as screening costs since screening is done by the clients

themselves and fosters repayment since “group *members have a reason to coax comrades out of arrears or even to repay their debts for them. Members may also act as mentors for each other* (Schreiner, 2001, p.5-6).

However, group lending or joint liability has its own problems, which have to do with the costs especially to the clients in terms of time for synchronous activities and having well performing clients pay for other people’s irresponsibility in case of default by one or more group member. Institutions like BancoSol combine both group and individual lending, giving clients the choice and catering for the various categories of clients who can benefit from the advantages each of the lending method has.

Lenders also need to take more risk by relaxing the rigid entry requirements to allow more people to have access to credit programmes. To compensate for this facility they could impose compulsory savings or the establishment of an emergency fund for which borrowers are required to contribute, just like in the case of the Grameen Bank where “...a *payment of 0.5% of every unit borrowed by the clients [is channelled towards the fund]*” (Khawari, 2004, p.23). According to Reinke (1996) *others [lenders] tap local knowledge by requiring character certificates from local worthies who are compensated according to the performance of their flock* (p.10).

Other commonly used safeguards, which are less traditional and help foster access, relationship building and sustenance include: progressive lending, frequent repayment schedules and auxiliary services. Progressive lending entails the granting of smaller loans in the beginning with the promise of larger loans in the future depending on the risk profile of the client. This process helps lenders and borrowers get to know each other over time.

Frequent repayment schedules also have the same effect. It makes it easier for lenders to monitor clients and above all it ensures that lenders and borrowers are in constant contact, hence the development of close long-term relationships (de Aghion and Morduch 2000). All these risk management mechanisms can constitute critical safeguards against opportunism while facilitating the entrance of many credit constrained people into credit programmes.

In terms of benefits, this study has come to the conclusion that relationships play an important role in credit programmes involving the target group that typically require small loans. Relationships can be considered to be cost-minimizing mechanisms based on repetitive interaction between lenders and clients. This study has found that this repetitive interaction or close long-term relationship between lenders and borrowers is important for reducing lending related risks that have to do with asymmetric information.

Further, by investing in building relationships with clients, institutions help form social capital skills that enable the target group gain access to increased flows of credit at a lower cost and at improved terms and conditions. Additionally, when lenders and borrowers are closely related, lending processes become more flexible, as the lenders can more easily predict and control the behaviour of the borrowers. When this happens clients get quick, easy and increased access to credit and other financial and non-financial services, which can render the use of relationship lending profitable and welfare improving.

7.1 Summary of lessons learned

- A long-term relationship is more valuable for both lenders and clients than a one-off arm's length transaction. Repeat borrowers are less expensive for the

institutions given those levels of supervision and monitoring for this group of clients is lower compared to those for first time or one off-borrowers. As such institutions should strive to retain their clients in order to be sustainable and produce greater social impact.

- Establishing close long-term relationships with clients is good for both clients and lenders. It makes it easier for lenders to tailor loans and other services to individual demand, but more importantly to individual capacity and willingness to repay loans. Loan granting decisions are taken and communicated more quickly, saving lots of time and resources in the process.
- While both lenders and borrowers play an important role in relationship lending, lenders bear most of the responsibility in the relationship building process, particularly because they are the ones making the decision whether to extend credit to applicants or not.
- Dealing with clients in a personalised (one to one) way is instrumental for building and sustaining client lender relationships. This makes it easy for them to take each others concerns on board and they both benefit from the relationship.
- When dealing with the target group, keeping entry requirements particularly the documentations as simple, flexible and realistic as possible is important for attracting and retaining clients in credit programmes hence the establishment of long-term relationships between lenders and borrowers.

- Providing quality services and support to clients is an important ingredient for relationship building and sustenance, and for the success of lenders. Client satisfaction and loyalty is displayed through clients' testimonials or referrals and their commitment to their contractual obligations.
- Greater emphasis on social mobilisation, transparency and communication is important for attracting and retaining the poor into credit relationships. Considering that the poor are risk averse, institutions need to make extra efforts to lure and retain them in the credit relationship. Findings from the study have shown that it is possible to attract client into a relationship through social mobilisation and keep them in the relationship by providing with quality services and support. However, levels of outreach are still low due to factors ranging from stiff entry requirements particularly the collateral and co-signer requirement.
- When dealing with the poor, it is important to employ non-traditional mechanisms for managing risk and delinquency: these include, reduced collateral requirements, requiring clients to open savings accounts, frequent repayment schedules, short terms to maturity, small initial loan sizes, subsequent improvement in terms and conditions etc. Lenders can reach poorer clients by allowing loan officers to admit into credit programmes a small percentage of clients who do not meet the requirements for entering credit relationships. Grameen bank for example encourages each of its loan officers to include a beggar in their borrower portfolios, hence its reputation for sustainability and greater social impact.

- Training and mentoring programmes are as important as credit itself; as such lenders should develop integrated programmes that combine credit, savings, training and other services in order to produce greater results and social impact.
- Relationship lending is not a solution to the problems of access to credit by the poor particularly because it is mostly those already in the credit programmes who enjoy the benefits of long-term relationships with lenders. Access to credit is still a huge problem, because most of the poor can not meet most of the requirement for entering credit programmes; as such there is need for other programmes such as safety nets to help the poorest of the poor rise to a level they can afford to enter credit programmes.

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APPENDICES

Appendix –I Outreach indicators for institution A

OUTREACH INDICATORS FOR INSTITUTIONS “A” FOR THE PERIOD 2000-2005

Outreach indicators	31/12/05	31/12/04	31/12/03	31/12/02	31/12/01	31/12/00
Number of Personnel	268	210	173	130	n/a	n/a
Number of active borrowers	15,587	11, 350	8, 178	7, 277	3, 168	301
Average loan Balance per borrower (US\$)	531	608	357	287	253	358
Loans below US\$300	n/a	42.50%	44.42%	59.48%	0.00%	27.00%
Woman borrowers	41.10%	43.70%	52.60%	61.80%	55.20%	49.80%
Average loan balance for borrower/GNI per Capita	n/a	243.13%	169.84%	143.62%	126.63%	170.24%
Number of savers	41,648	22, 954	16,125	7,990	296	n/a
Average loan balance per saver (US\$)	127	156	133	101	103	n/a
Average saving balance for saver/GNI per Capita	n/a	62.37%	63.53%	50.70%	51.25%	n/a

Source: MixMarket

Appendix –II Financial indicators for institution A

FINANCIAL INFORMATION FOR INSTITUTION “A” FOR THE PERIOD 2000-2005

Financial information in US\$	31/12/05	31/12/04	31/12/03	31/12/02	31/12/01	31/12/00
Balance sheet						
Gross loan portfolio	8,279,743	6,898,665	2,916,745	2,090,196	802,309	107,611
Total assets	10,989,578	10,686,872	4,562,544	2,977,837	1,486,190	1,514,282
Savings	5,301,792	3,579,124	2,151,152	810,107	30,341	0
Total equity	2,781,770	3,816,742	2,179,471	958,869	1,120,138	1,380,311
Financial Structure						
Capital/ Asset Ratio	25.31%	35.71%	47.77%	32.20%	75.37%	91.15%
Debt/Equity Ratio	295.06%	180.00%	109.34%	210.56%	32.68%	9.71%
Deposits to loans	64.03%	51.88%	73.75%	38.76%	3.78%	0.00%
Deposit to total assets	48.24%	33.49%	47.15%	27.20%	2.04%	0.00%
Gross loan portfolio/Total assets	75.34%	64.55%	63.93%	70.19%	53.98%	7.11%
Overall Financial Performance						
Return no Assets	-2.45%	1.99%	-7.52%	-6.35%	-5.21%	n/a
Return on Equity	-8.03%	5.06%	-18.07%	-13.64	-6.25%	n/a
Operational self-sufficiency	94.34%	103.81%	85.99%	88.62%	79.17%	14.41%
Revenues						
Financial revenue Ratio	40.75%	54.22%	46.16%	49.49%	19.80%	n/a
Profit Margin	-6.00%	3.67%	-16.29%	-12.84%	-26.32%	-594.0%
Expenses						
Total Expense Ratio	43.19%	52.23%	53.69%	55.84%	25.02%	n/a
Financial Expense Ratio	6.34%	5.68%	9.22%	12.21%	0.61%	n/a
Loan Loss Provision Expense Ratio	1.45%	3.67%	2.75%	3.48%	1.59%	n/a
Operating expense Ratio	35.40%	42.87%	41.71%	40.15	22.82%	n/a
Efficiency						
Operating Expense/Loan Portfolio	50.56%	66.60%	62.82%	61	n/a	n/a
Cost per Borrower	284.9	334.8	203.5	171.6	197.4	n/a
Productivity						
Borrowers per Staff member	58	54	47	56	n/a	n/a
Savers per Staff member	155	109	93	61	n/a	n/a
Risk						
Portfolio at Risk>30 days Ratio	1.81%	3.38%	2.17%	2.14%	0.53%	n/a
Loan Loss Reserve Ratio	5.02%	5.26%	2.16%	1.83%	3.42%	3.36%
Risk coverage Ratio	277.24%	155.34%	99.53%	85.37%	638.40%	n/a
Write Off Ratio	1.26%	0.54%	1.58%	0.22%	n/a	n/a

Source: MixMarket

Appendix -III Outreach indicators for institution B

OUTREACH INDICATORS FOR INSTITUTION “B” FOR THE PERIOD 2000-2005

Outreach indicators	31/12/05	31/12/04	31/12/03	31/12/02	31/12/01	31/12/00
Number of Personnel	134	97	77	71	54	65
Number of active borrowers	6,377	5,861	5,931	5,485	2,904	1,742
Average loan Balance per borrower (US\$)	838	711	332	270	223	365
Loans below US\$300	n/a	n/a	n/a	26.80%	31.70%	30.00%
Woman borrowers	58.48%	53.00%	53.00%	52.00%	52.00%	51.80%
Average loan balance for borrower/GNI per Capita	n/a	284.53%	158.21%	135.02%	111.25%	173.87%
Number of savers	3,172	420	0	0	0	0
Average loan balance per saver (US\$)	254	132	n/a	n/a	n/a	n/a
Average saving balance for saver/GNI per Capita	n/a	52.82%	n/a	n/a	n/a	n/a

Source: MixMarket

Appendix -IV Financial indicators for institution B

FINANCIAL INFORMATION FOR INSTITUTION "B" FOR THE PERIOD 2000-2005

Financial information in US\$	31/12/05	31/12/04	31/12/03	31/12/02	31/12/01	31/12/00
Balance sheet						
Gross loan portfolio	5,345,830	4,169,153	1,970,572	1,481,185	646,154	636,036
Total assets	8,061,544	5,481,744	3,291,247	2,106,224	923,385	982,020
Savings	806,929	55,465	0	0	0	0
Total equity	2,913,900	1,920,868	1,241,729	932,902	134,771	116,055
Financial Structure						
Capital/ Asset Ratio	36,15%	35.04%	37.73%	44.29%	14.60%	11.82%
Debt/Equity Ratio	176,66%	185.38%	165.05%	125.77%	585.15%	746.17%
Deposits to loans	15,09%	1.33%	0.00%	0.00%	0.00%	0.00%
Deposit to total assets	10,01%	1.01%	0.00%	0.00%	0.00%	0.00%
Gross loan portfolio/Total assets	66,31%	76.06%	59.87%	70.32%	69.98%	64.77%
Overall Financial Performance						
Return no Assets	0,71%	1.83%	7.45%	-2.30%	3.12%	n/a
Return on Equity	1,99%	5.07%	18.50%	-6.53%	23.70%	n/a
Operational self-sufficiency	103,52%	111.07%	126.69%	100.41%	108.49%	87.89%
Revenues						
Financial revenue Ratio	41,89%	52.76%	50.38%	46.67%	39.89%	n/a
Profit Margin	3,40%	9.97%	21.07%	0.41%	7.82%	-13.78%
Expenses						
Total Expense Ratio	40,46%	47.50%	39.77%	46.48%	36.77%	n/a
Financial Expense Ratio	8,02%	4.77%	6.45%	5.94%	0.94%	n/a
Loan Loss Provision Expense Ratio	1,93%	1.75%	1.64%	3.00%	1.56%	n/a
Operating expense Ratio	30,51%	40.97%	31.68%	37.55%	34.27%	n/a
Efficiency						
Operating Expense/Loan Portfolio	43,43%	58.55%	49.53%	53.47%	50.92%	n/a
Cost per Borrower	337,7	304.8	149.8	135.6	140.5	n/a
Productivity						
Borrowers per Staff member	48	60	77	77	54	27
Savers per Staff member	24	4	0	0	0	0
Risk						
Portfolio at Risk>30 days Ratio	0,69%	0.36%	0.30%	0.07%	0.30%	0.32%
Loan Loss Reserve Ratio	2,40%	2.22%	2.02%	2.46%	3.68%	3.04%
Risk coverage Ratio	347%	620.81%	664.35%	3,455.11%	1,239.60%	963.64%
Write Off Ratio	1,85%	1.27%	2.36%	2.46%	0.64%	n/a

Source: MixMarket

Appendix –VI Interview questions

The interview questions (which were semi-structured) sought to explore the following issues:

- Whether the lenders and the target group are engaged in short or long-term credit relationships-judged by levels of repeat borrowing and incentive structures to keep clients in the credit programmes
- Whether target groups have been sensitized about, and that the target groups actually understand, the benefits and potential risks of taking loans
- Whether target groups are acquainted with the bureaucratic and procedural exigencies they need to follow to obtain loans and repaying them
- Whether the clients find the institutions useful and affordable, and are interested in taking loans from the same institutions repetitively for a long period or are just interested in a one off loan
- Whether the target groups understand that in order for the institutions to be at their service in the long-term they need to run at a profit and that their repayment behaviour is important for the sustainability of the institutions.
- Whether the target groups feel that the institutions and the loan officers are receptive, helpful and friendly enough in dealing with them and responding to their needs
- Whether they feel that the institutions are not only concerned with making profits but also with their wellbeing,
- Whether credit products respond to the needs of the target groups and they actually have a say in the establishment of terms and conditions

- Whether there is an improvement in terms and conditions for well performing clients
- How much the institutions value profit making and how they balance the need for profit and lending to the poor
- What the institutions do to ascertain that lending does not lead to high default rates and indebtedness
- What the institutions do to make credit more accessible while ensuring repayment
- What the institutions do to encourage repayment, increase borrower portfolio and keep well performing clients in the programmes for a long time.
- What the clients do to assure that they have permanent access to credit programmes
- Whether the institutions keep in touch with potential clients and active clients before and after loans are disbursed, not only to monitor creditworthiness and the use to which loans are put, but also to assist borrowers by responding quickly and un-bureaucratically to changes in the market

Appendix -VII List of interviewees

Name of interviewee	MFI to which the interviewee belongs	The activity (business) done by the interviewee	Place of interview	Date of the interview
Abilio	A	Sells food and drinks	Business Premises	09/01/06
Amelia	None	Hair Saloon	Home	05/10/2006
Borris	A	Senior officer	office	08/02/2006
Caetono	B	Carpenter	Home	15/02/2006
Carlos	B	Senior officer	Office	30/01/2006
Castigo	B	Buys and sells goats	B. Premises	10/02/2006
Chicamisse	A	Buys and sells cereals	B. Premises	30/01/2006
Chipanela	None	Sells drinks and food	Home	09/10/2006
Chitima	A	Sells Vegetables	B. Premises	06/02/2006
Cufa	B	Repairs bicycles	B. Premises	09/01/2006
Garicai	A	Loan officer	Office	12/01/2006
Joana	A	General retailer	B. Premises	07/02/2006
Joaninha	B	Has a hair saloon	B. Premises	10/02/2006
Joao	B	Sells building material	B. Premises	07/02/2006
Jone	None	Sells parts	B. Premises	09/10/2006
Laise	A	Makes and sells pots	B. Premises	18/01/2006
Lorenco	A	Runs a canteen	Home	30/01/2006
Luisa	B	Loan officer	Office	03/02/2006
Maita	A	Sells food and drinks	Home	20/01/2006
Marcos	B	Sells fish	B. Premises	09/01/2006
Marta	None	Tailor	B. Premises	11/10/2006
Memba	B	Sells parts	B. Premises	19/01/2006
Miguel	A	Loan officer	Home	16/02/2006
Muti	A	Sells second hand cloths	B. Premises	18/01/2006
Nkala	B	Sells meat	Home	26/01/2006
Pedro	B	Runs a small shop	B. Premises	31/01/2006
Pita	None	Sells building materials	B. Premises B	12/10/2006
Rosa	B	Loan officer	Office	03/02/2006
Tatenda	A	Brews home made beer	B. Premises	26/01/2006
Tichaona	A	Runs a small shop	B. Premises	08/02/2006
Wadzanai	A	Tailor	B. Premises	18/01/2006